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Supreme Court of the United States

OCTOBER TERM, 1943.

No. **490**

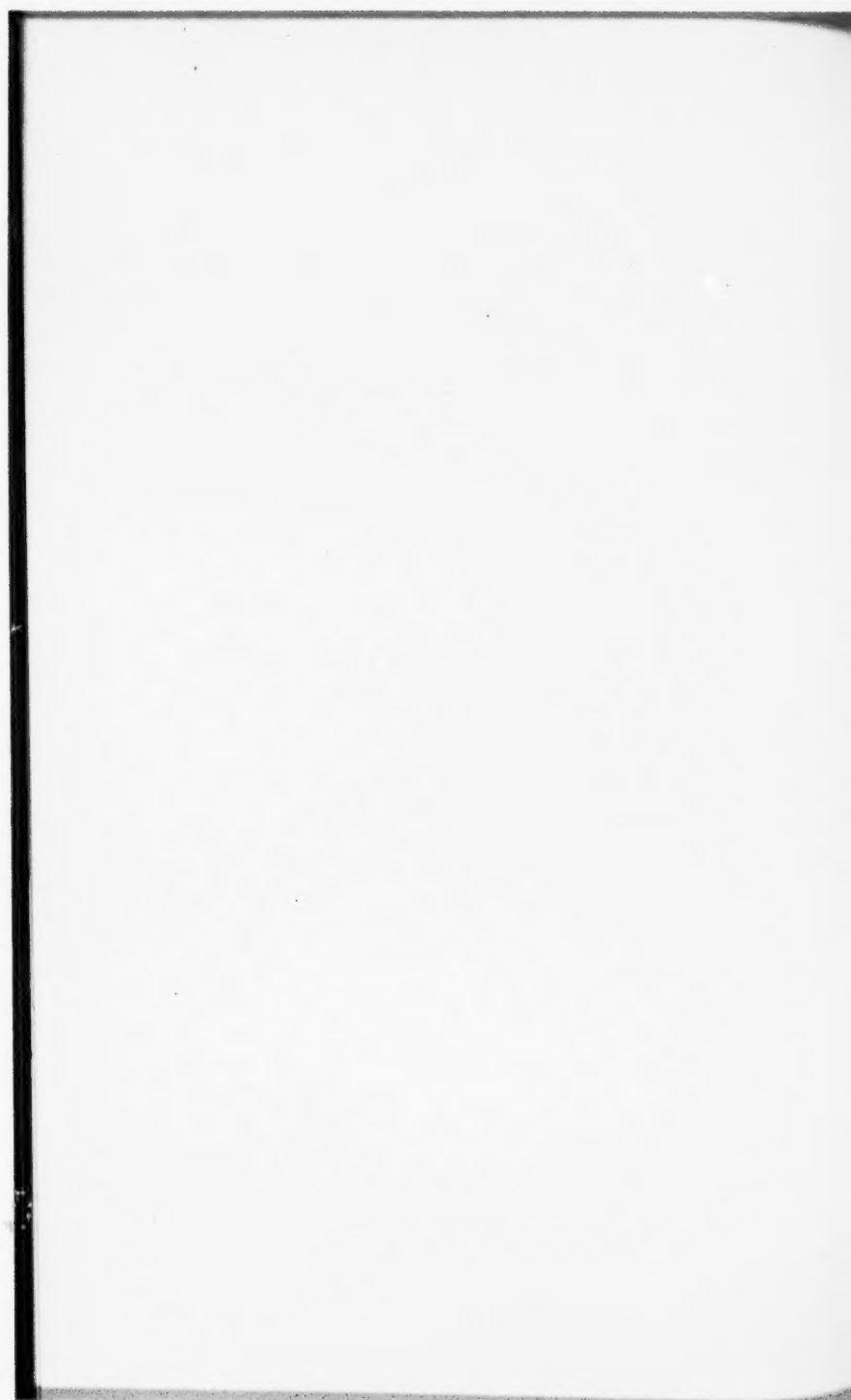
TRICO PRODUCTS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**PETITION FOR WRIT OF CERTIORARI AND
BRIEF IN SUPPORT OF PETITION.**

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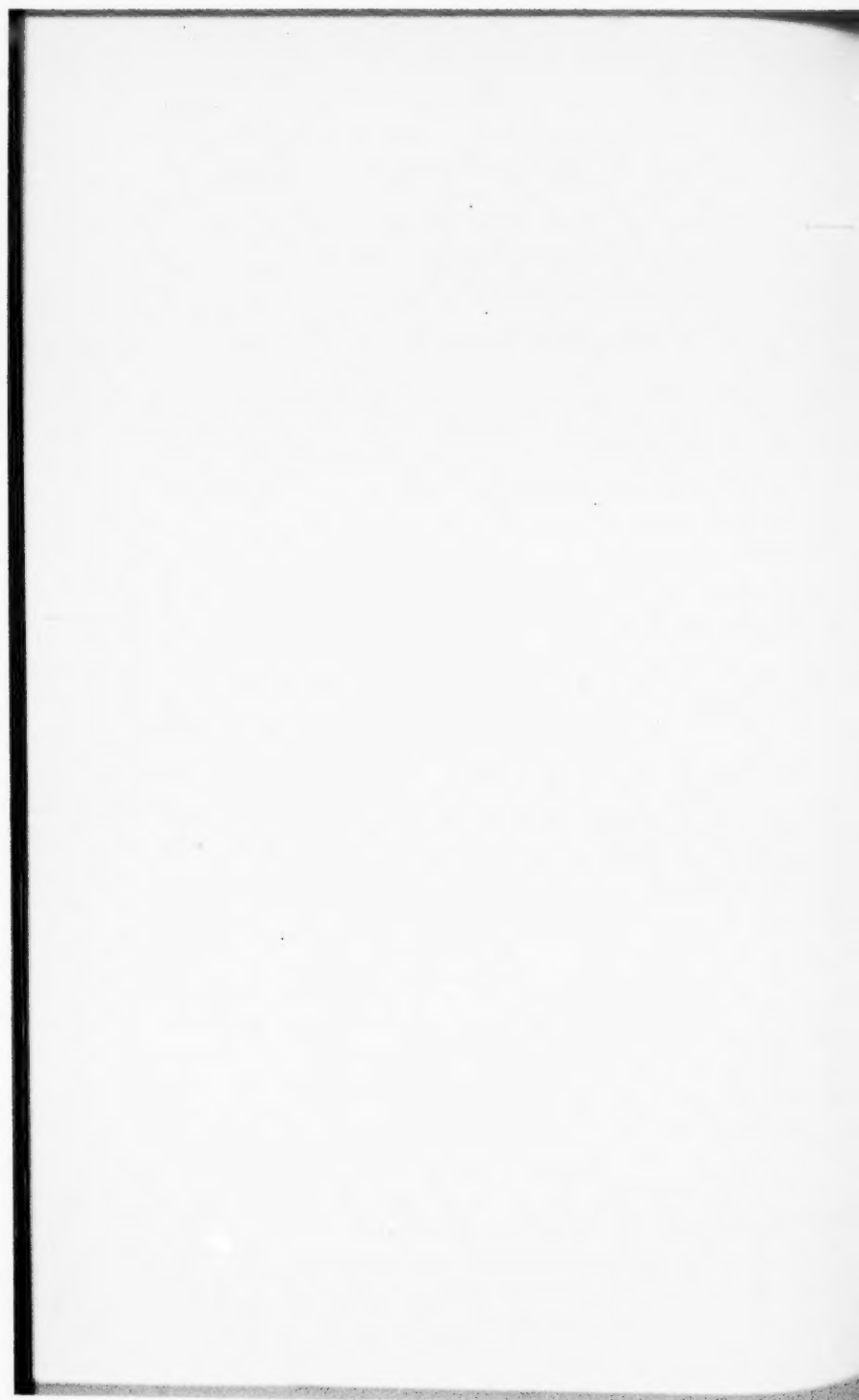
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TRICO PRODUCTS CORPORATION,
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v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI.

*To the Honorable the Chief Justice of the United States and
the Associate Justices of the Supreme Court of the
United States:*

Trico Products Corporation prays that a writ of certiorari issue to the United States Circuit Court of Appeals for the Second Circuit to review a judgment of that Court rendered in the above cause on August 19, 1943 (R. 390), affirming a decision of the United States Board of Tax Appeals (now known and herein referred to as the Tax Court) finding a deficiency in the federal income tax of petitioner of \$413,439.31 for the calendar year 1934 and of \$1,220,933.44 for the calendar year 1935 (R. 105). Except for small deficiencies aggregating \$16,440.86 which were not contested on appeal, these deficiencies were for corporate surtaxes assessed under Section 102 of the Revenue Act of 1934, 48 Stat. 702. The petition presents

questions of great importance generally as to the basis of the heavy penal tax provided for by that Section.

Jurisdiction.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended (28 U. S. C. A. § 347(a)).

The Opinions of the Courts Below.

The opinion of the Tax Court (R. 46) is reported in 46 B. T. A. 346. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 370) is reported in 137 F. (2d) 424.

Statute Involved.

Section 102, *Revenue Act of 1934*, 48 Stat. 702, so far as here material, provides as follows:

“Sec. 102. Surtax on Corporations Improperly Accumulating Surplus.

“(a) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

“(1) 25 per centum of the amount of the adjusted net income not in excess of \$100,000, plus

“(2) 35 per centum of the amount of the adjusted net income in excess of \$100,000.

“(b) *Prima Facie Evidence*.—The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax.

“(c) Definition of ‘Adjusted Net Income’.—As used in this section, the term ‘adjusted net income’ means the net income computed without the allowance of the dividend deduction otherwise allowable, but diminished by the amount of dividends paid during the taxable year.”

Summary Statement of Matter Involved.

Petitioner maintains that the heavy penalty surtax assessments made in this case were based on fundamental errors of law made by the lower courts.

Petitioner's position is that under a correct construction of Section 102 of the Revenue Act of 1934, a corporation is subject to the penalty surtax imposed thereby only where the fact-finding tribunal determines on the evidence that the purpose of preventing the imposition of individual surtax liability on shareholders was at least a substantial factor inducing the accumulation of profits. The Tax Court made an error of law in construing the statute as imposing liability unless the complete absence of such a purpose is shown. The reviewing court failed to correct this fundamental error. The construction of the statute here sought to be reviewed conflicts in principle with *United States v. Wells*, 283 U. S. 102 (1931), a “contemplation of death” case. Both courts also erred in failing to recognize that the *prima facie* effect given by the statute to a finding of accumulation beyond reasonable business needs disappears

upon introduction of positive evidence as to the actual purposes of the accumulation. This construction is in conflict with the recent decision of the Circuit Court of Appeals for the 9th Circuit in *Hemphill Schools, Inc. v. Commissioner*, 137 F. 2d, 961 (1943).

The Tax Court in this case made no finding that the purpose of preventing the imposition of surtax on shareholders was a substantial factor inducing the accumulations made by the petitioner in the taxable years 1934 and 1935 and sustained the assessments on an erroneous construction of the statute. The reviewing court did not and could not have made the finding essential to liability. Such a finding as to purpose is not made unnecessary by the finding of the Tax Court, on conflicting evidence, that petitioner's accumulations had been beyond reasonable business needs since substantial, affirmative and undisputed evidence was introduced that the accumulations were actually motivated by purposes wholly unrelated to tax considerations.

Facts.

The accumulations in question were for 1934 and 1935 (see p. 9 below). The significance of these accumulations and the motives which induced them must be determined in the light of the setup and practice of the petitioner. The legal points presented are clear, but a statement of the facts in some detail is necessary to indicate their bearing and importance in this case.

Petitioner in 1934 and 1935 was a substantial, growing manufacturing company—not a mere holding or investment company—actively engaged in making automatic windshield wipers for automobiles under patents expiring in 1942 (R. 47-48). It had approximately 1,780 stockholders in 1934 and 2,200 stockholders in 1935 (R. 176). Its largest single individual stockholder owned directly and indirectly

about 23% of the stock; he and a group of some 20 other original stockholders owned directly and indirectly about 76% of the stock (R. 355, 364). Petitioner concededly was not formed for the purpose penalized by the statute; it made no loans to stockholders; its stockholders had transferred no income-producing property to it for stock or as paid-in surplus. It paid substantial and increasing dividends from year to year (R. 58) under an established and publicly announced dividend policy adopted in 1928 and continued, without change, through 1934 and 1935, the tax years in question (R. 57).

This is the first case in which a corporation, so situated, has been held by the courts to be subject to the penalty surtax under Section 102 or similar sections of the Revenue Acts.

Formation and Growth of Petitioner.

J. R. Oishei, the President of the petitioner, started the business in 1917 and organized petitioner in 1920 (R. 47). The real growth of the business dates from 1921, when Mr. Oishei invented the automatic vacuum windshield wiper, which ultimately became standard equipment on practically all automobiles (R. 67). Earnings, which were applied principally to building up the Company, grew as follows (R. 48, 61, 323, 325):

1920.....	\$ 52,000
1925.....	509,000
1926.....	921,000
1927.....	1,372,000

1927 Recapitalization and Sale of Stock.

The dividend practice of petitioner in all years subsequent to 1927, including the years 1934 and 1935 here in question, was a natural and legitimate outgrowth of a recapitalization and sale of stock which occurred in that

year. In September, 1927, the then stockholders, 21 in number (R. 48), after recapitalizing the Company so that its outstanding stock consisted solely of 675,000 shares of no par value common stock (R. 50), sold 175,000 shares (26%) to bankers (R. 50) who resold these shares to the public at \$31 per share (R. 310) or for some \$5,425,000. At that time the Company's net tangible assets were only about \$1,800,000 (R. 310, 316)—less than \$3 per share—its earning power was based almost entirely on basic patents expiring in 1942 (R. 48), and it was earning at the annual rate of \$1,370,000—about \$2 per share (R. 61). It was publicly announced that the stock sold to the public would be placed on an annual dividend basis of \$2.50 per share (R. 310, 316). This dividend rate on the entire 675,000 shares would have required annual dividends of \$1,687,500, more than the Company was earning.

This otherwise impossible sale of stock was made possible by the provisions of certain contracts (R. 272-289), insisted upon by the bankers (R. 94), which had no relation to tax considerations, and which operated as the primary cause of the dividend practice thereafter followed by the petitioner. Under the contract between all of the then stockholders and the Company (R. 279), the stockholders agreed that 450,000 of the 500,000 shares retained by them should be restricted by a "waiver" of dividends thereon up to \$2.50 per year. This provision reduced the current annual dividend requirement on the \$2.50 per share basis to \$562,500 payable on the 225,000 shares of "free" stock. This involved, however, a large increase over the dividends which petitioner had paid in prior years (R. 319, 325).

The dividend waiver under this contract was specifically stated to be "in consideration • • • of the conservation of earnings and working capital which this agreement

contemplates for the Company" (R. 280). The waiver was to be effective only until the earnings of the Company increased to specified amounts per free share plus the number of shares to be freed by such earnings. 112,500 shares were to be released from the dividend waiver in 1928 or later, as the corporate net earnings reached \$5.00 per share or \$1,687,500 for the last share in the \$5 block. Another 112,500 shares were to be released in 1929 or later, as the corporate net earnings reached \$6.00 per share or \$2,700,000 for the last share in the \$6 block. The remaining 225,000 shares were to be released as the corporate net earnings reached \$9.00 per share or \$4,050,009 to release the first share, and \$6,075,000 to release the last share in the \$9.00 block (R. 280). No release could be made in any year unless \$2.50 per share had been paid on the free shares in the preceding twelve months (R. 281). The Company also agreed not to liquidate voluntarily or recapitalize so long as any stock was subject to the dividend waiver (R. 282). The latter provision, while protecting the purchasers of the free stock against liquidation before assets had been substantially increased, also had the effect of limiting the sources from which petitioner could derive new cash capital or otherwise build up its assets to accumulated earnings and profits (R. 55).

Under the terms of the sale the restricted stock, all held by the old stockholders, was required to be placed in a voting trust to the end that the Company should "be managed and directed during the next ten years under a definite and fixed policy" (R. 272, 284). The voting trust was superseded in 1929 by the transfer of the restricted shares to Trico Securities Corporation, the stock of which was owned by the original stockholders of petitioner (R. 56). (The agreement with the bankers did not, as erroneously stated

by the Circuit Court of Appeals (R. 372), contain the provision for release of the restricted shares. This was a provision of the contract between the Company and the stockholders (R. 280-1.)

Thus from the outset the controlling stockholders, as the holders of the 450,000 shares of restricted stock, which was not marketable, had a goal of building up petitioner's assets and thereby increasing earnings to a point where the stock could be released, making it worth on the market \$13,950,000 (on the basis of a \$31 a share market price for the free stock), and entitling it to share equally with the other shares in all dividends distributed.

In placing before the management this strong inducement to accumulation, the purchasers of the free shares were insuring an effort on the part of the management to increase earnings and to build up the assets of the Company, so slender at the start, toward the sale price per share, were guarding against any voluntary liquidation of petitioner by the old stockholders before asset value had increased substantially, and also were making provision against the consequences of the expiration in 1942 of the Company's vital patent. There was no conflict of interest between the holders of the free and the restricted shares—the release of the restricted shares could be accomplished only by a process of building up assets and earnings, which would be beneficial to all.

Earnings and Distributions from 1928 through 1933.

The "definite and fixed" dividend practice of petitioner from 1928 through 1933 was to pay annually the publicly announced dividends of \$2.50 per share on its free stock and no dividends on its restricted stock on which such dividends had been waived (R. 57). The resulting distribu-

tions, in comparison with the earnings, were as follows (R. 58, 300):

	Net Income per books	Dividends	% of net income distributed
1928.....	\$ 1,797,821.56	\$ 655,243.09	36.45
1929.....	2,249,947.97	794,131.49	35.30
1930.....	1,908,415.88	914,052.47	47.90
1931.....	1,762,550.76	937,484.10	53.18
1932.....	964,964.32	937,484.85	97.15
1933.....	1,418,277.21	937,485.01	66.10
Total.....	\$10,101,977.70	\$5,175,881.01	51.23

The dividends declared in 1927 had been but \$357,023.38 (R. 319). This included dividends on preferred stock held by the old stockholders and retired as part of the recapitalization plan in 1927 (R. 55) and the quarterly dividend on the free shares paid January 2, 1928. Dividends prior to 1927 had been much smaller (R. 325). The immediate effect of the new dividend policy was thus a substantial increase in dividends.

During the period from 1928 through 1933, there was no substantial increase in the amount invested in operating assets, and the difference between earnings and distributions was largely accounted for by investments in securities of some \$4,000,000 (R. 59, 299). Petitioner's status at December 31, 1933 has at no time been questioned by the Government, so far as Section 102 is concerned, and hence must be regarded as furnishing no basis for assertion of liability under Section 102 (see R. 23-25).

Earnings and Distributions in 1934 and 1935 and Later Years.

During 1934 and 1935, the tax years in question, petitioner continued its established policy of paying annually \$2.50 on its free stock and no dividends on its restricted

stock (R. 57). Its earnings for 1934, and for 1935 when the automobile business greatly expanded, and the disposition thereof, were as follows (R. 58, 59, 61, 67):

	1934	1935
Earnings	\$1,771,558.53	\$3,567,404.42
Dividends	937,485.62(53%)	925,322.70(26%)
Difference	\$ 834,072.91	<u>\$2,642,081.72</u>
<i>Less:</i>		
Increase in operating assets	296,251.00	\$1,801,967.31
Purchase of treasury stock*		<u>476,224.29</u>
		<u>\$2,278,191.60</u>
Balance	\$ 537,821.91	\$ 363,890.12

If petitioner had distributed an additional dividend of 80¢ per share on all its stock in 1934 and 54¢ per share in 1935, or an aggregate of \$901,712.03 for the two years, it would have distributed every dollar of 1934 and 1935 income not reflected in increased operating assets or paid out to acquire treasury stock. Under the decision of the Court below, petitioner is penalized a total of \$1,617,931.89 (R. 29, 32) for permitting these accumulations to take place.

The increase in the amount of securities held at the end of 1935 over the amount held at the end of 1933 (R. 59) reflected in part a large increase in current liabilities (R. 60) as well as increases in reserves for depreciation and amortization of patents (R. 299).

* These purchases were made in connection with a 10-year contract between petitioner and General Motors Corporation, its largest customer, which provided for payments by petitioner to General Motors, by way of participation in profits. Petitioner had the option of making annual settlements either in cash or in its own stock (R. 63).

The dividend practice begun in 1928 was continued without substantial change up to the date of the hearing in December 1940, except that extra dividends of \$1.37½ per share were paid on all the shares in 1936 and 1937. These exceptional distributions were made because of the tax imposed on Undistributed Profits in those years (R. 57). That tax was later repealed (see p. 35 below).

Shares Owned by Largest Stockholders in 1934 and 1935.

During the tax years in question, the largest individual stockholders, directly and through Trico Securities Corporation, held the following percentages of petitioner's outstanding stock:

	Jan. 1, 1934	Jan. 1, 1935	Dec. 31, 1935
John R. Oishei.....	22.9%	23.2%	23.5%
Peter C. Cornell.....	20.8%	21.7%	21.9%
C. H. Oishei.....	12.2%	10.5%	5.2%
S. H. Evans.....	9.7%	9.7%	10.0%
Ieuan Harris.....	4.3%	4.4%	4.7%

(Percentages computed from data at R. 355 and 364.)

The balance of the stock was held in smaller amounts by some 1,780 to 2,200 other stockholders (R. 176).

Release of Stock from Dividend Waiver.

Although the petitioner's earnings decreased due to the depression as shown at page 9, *supra*, the earnings steadily increased after 1932 and reached \$4,184,560 in 1936 (R. 61). This growth was due both to expansion of the business and growing investments in securities. Petitioner's earnings

resulted in the release of shares from the dividend waiver as follows (R. 61, 290):

Released by earnings of	Shares released after close of year
1927	49,460
1928	63,040 (last of \$5 block)
1929	37,491
1935	75,009 (last of \$6 block)
1936	14,951 (first of \$9 block)
Total shares released.....	239,951

The shares so released, which were virtually unmarketable as restricted shares (R. 159, 176, 182), had a market value as free shares of more than \$7,400,000 on the basis of a sale value of \$31 per share. The free shares, which had sold for \$31 per share in 1927, were selling at \$34 per share at the time of the hearing in December, 1940; in the interval they had fluctuated from a low of \$19 to a high of \$62 per share (R. 66, 182). The 450,000 shares of stock originally subject to the dividend waiver had a potential value of \$13,950,000 as free shares at \$31 per share.

Other Objectives Accomplished.

In addition to releasing over half of the restricted stock by 1937, notwithstanding the depression, the dividend practice of petitioner enabled the substantial accomplishment of the other objectives of the 1927 agreements, including the insuring of annual dividends of \$2.50 per share on all free shares, the progressive increase of the annual earnings of the Company and the building up of the net asset values behind the stock. The net asset value per share, which was about \$3 per share in 1927 when the free shares were sold to the public at \$31 per share, increased to \$10.37 per share

by December 31, 1933 and to \$15.14 per share by December 31, 1935 (computed from data at R. 299).

The dividend practice followed also enabled petitioner to meet a number of other problems peculiar to its unique position in the automobile industry. From 1932 on, petitioner was practically the sole supplier of automobile windshield wipers for automobiles (R. 67). A substantial part of its business was with the largest automobile manufacturers (R. 68) over which petitioner had no control. This made it absolutely essential for petitioner at all times to have sufficient resources promptly to meet the needs and demands of the automobile industry, which was rapidly expanding in 1934 and 1935 (R. 67, 184-186). By reason of the 1927 contracts petitioner could not recapitalize and would find it difficult to borrow (R. 55). Under the dividend policy of petitioner, it was possible to meet this need. From the beginning of 1934 to the end of 1939 petitioner's investment in operating assets increased by over \$5,600,000 (R. 59). From 1936 to 1939 petitioner expended almost \$2,400,000 for additions to productive capacity because it was unable with its previously existing facilities to take care of the demands of the industry although operating under three 8-hour schedules (R. 69). Its gross sales during those four years were equal to gross sales for the *eight* years from 1927 to 1935, inclusive (R. 68).

Petitioner was also confronted with the fact that in 1942 the basic patents were to expire on the windshield wiper, which was its major source of income. To meet this problem it conducted extensive experiments in search of new products, and at the end of 1935 set aside a large fund for anticipated diversification of products (R. 70, 71, 320). This policy bore fruit in the form of an automatic device for raising and lowering automobile windows, intro-

duced to the automobile trade in 1940 and enthusiastically received by it (R. 71, 297). The adoption of this device on 1,000,000 cars a year would require plant expansion by petitioner of an estimated cost of between \$3,000,000 and \$5,000,000 and would double petitioner's production (R. 72).

Thus, the dividend policy of petitioner was designed to meet the peculiar requirements of this Company, as well as to carry out the purposes of the 1927 contracts. That this policy was not the result of motives on the part of the principal stockholders which conflicted in any respect with general corporate purposes, whether by way of tax considerations or otherwise, is further shown by the fact that it had the full approval of an independent director, Paul A. Schoellkopf, representing Niagara Share Corporation, which had purchased in the market 16,000 free shares (R. 49, 227-231).

Effect of Dividend Policy on Tax Liability of Principal Stockholders.

It is far from the fact that the 21 original stockholders diminished their own receipt of dividends by causing petitioner to follow the dividend practice described. The fact is that, despite the sale in 1927 of a substantial part of their stock in the Company, they increased their receipt of dividends. The dividends payable on the 50,000 free shares which the old stockholders retained in 1927, plus the additional shares subsequently freed and owned by them directly or indirectly, were as follows (computed on the basis of \$2.50 per share on 50,000 shares plus shares released):

1928.....	\$248,650
1929.....	306,250
1930-1935.....	499,977.50 per year
1936.....	687,500
1937.....	724,877.50

In addition there were the extra dividends of \$1.37½ per share on all the shares in 1936 and 1937, paid because of the undistributed profits tax in effect for those years (R. 57).

The dividends received from 1928 on were much larger than had been received by the old stockholders on the common stock in any year prior to 1928 (R. 319, 325).

In the cases of J. R. Oishei and P. C. Cornell, the two largest stockholders of petitioner, the increase in dividends payable on free stock which they owned directly or indirectly was as follows:

Dividends at \$2.50 per share on free stock owned directly or indirectly at December 31—		
	1927	1935
Mr. Oishei*	\$29,542.50	\$153,220.00
Mr. Cornell*	34,558.50	150,837.50

Additional shares were released in 1936 and 1937, thereby further increasing the dividends payable to the principal stockholders (R. 61).

From a long range viewpoint, the practice followed had the effect of building up the incomes of the controlling shareholders and the value of their holdings in the only way in which this could be done, that is by building up petitioner's earnings by expanding the investment in plant, equipment and operating capital as rapidly as possible and keeping surplus funds invested in securities pending their absorption into the manufacturing business. The entire

* As of December 31, 1927 Mr. Oishei owned directly or indirectly only 11,817 free shares, and Mr. Cornell only 13,783 shares (R. 363). As of December 31, 1935 Mr. Oishei owned directly 43,288 free shares and was beneficial owner of about 31% of the 57,260 free shares then held by Trico Securities Corporation; and Mr. Cornell owned directly 44,015 free shares and was beneficial owner of about 28% of the 57,260 free shares owned by Trico Securities Corporation (R. 355, 364).

accumulations up to the end of 1935 were actually absorbed in operating assets within four years thereafter (R. 59).

Turning to the other side of the picture, namely, the alleged surtax savings from failure to make additional distributions, the Tax Court stated that in 1934 and 1935 the controlling stockholders "saved in surtaxes not less than \$840,000" (R. 96). This conclusion rests on fallacy. It was based on computations as to surtaxes which would have been paid currently if every dollar of 1934 and 1935 income had been distributed as dividends (R. 366). This would have required additional distributions of over \$3,475,000 for the two years, when actually there was available for distribution from the income of those years, after increases in operating assets and purchases of treasury stock, only \$901,712.03 (see computation above, page 10). If petitioner had distributed as dividends all of its income for 1934 and 1935 not reflected in increase in operating assets and purchases of treasury stock, the additional current surtaxes of the stockholders in question for both 1934 and 1935 would have been less than one-fourth of the amount assumed by the Tax Court. For the more important year 1935, such distribution would have been but 14½% of the distribution assumed by the Tax Court.

The Testimony.

Respondent's only witness was an auditor who testified as to certain computations (R. 246-250).

Petitioner's witnesses included the representative of the bankers in the 1927 transaction and the bankers' counsel. They also included a majority of petitioner's Board of Directors in 1934 and 1935. These directors were the individuals whose "purpose" was to be ascertained. All testified without contradiction that neither the 1927 contracts

nor the dividend practice based thereon were entered into or adopted for any purpose of avoiding surtaxes on the shareholders, and that tax considerations had not entered into the matter at any time (R. 160, 170, 177, 225-228, 233, 234, 236, 237, 239).

This testimony did not consist merely of categorical denials of the existence of the condemned purpose. It was coupled with positive and unshaken testimony concerning the facts and circumstances surrounding the matter, showing that the dividend practice was adopted and continued in the light of and on the basis of the 1927 contracts. The direct testimony of the witnesses, supported by the evidence as to facts and circumstances, was that the accumulations had two complementary purposes: (a) to increase corporate earning power and thereby secure by the only available means the release as soon as possible of additional shares from the dividend waiver, thus building up the current incomes (and consequently the taxes) of the principal stockholders, and greatly increasing the value of their holdings, as well as fulfilling the other purposes of the 1927 contracts (R. 158, 172, 173, 176, 177, 199, 229, 235, 236, 239, 242), and (b) to take care of the growing business needs of the Company to keep it in a strong position as sole supplier to the automobile industry of an indispensable accessory and to enable it to expand and develop new products, particularly in view of the fact that it could not issue new stock and would find it difficult to borrow and of the expiration in 1942 of the basic patents on the windshield wiper (R. 184-186, 189, 203-204, 224-225, 229-230).

There was substantial, affirmative and uncontradicted evidence that the actual purpose of the accumulation of profits was wholly other than that of avoidance of surtaxes. There was no affirmative evidence that surtax avoidance was a motivating purpose.

The Decisions Below.

The Tax Court, after finding all of the subsidiary facts as to which there is no dispute, including the mathematical fact that if additional distributions had been made the shareholders would have paid currently greater surtaxes, found (a) that during the taxable years petitioner permitted its gains and profits to accumulate beyond the reasonable needs of its business, and (b) in the language of the statute, that during the taxable years petitioner was availed of for the purpose of preventing the imposition of the surtax upon its shareholders and the shareholders of another corporation through the medium of permitting its gains and profits to accumulate instead of being divided or distributed (R. 73).

It is clear from the opinion of the Tax Court, however, that in purporting to make the finding as to purpose, essential to liability, it erroneously construed the statute as not requiring the condemned motive to contribute substantially, or to any material degree, in causing the accumulation. Thus, the Tax Court stated that there must be a "complete lack of the condemned purpose" (R. 89); that it must be convinced of "the complete innocence of petitioner's purpose" (R. 89), and that "there was no taint of a purpose" to avoid surtaxes (R. 98); that petitioner must prove a "complete lack" and "absence" of the condemned purpose "regardless of what other purposes it may prove" (R. 89, 90); and that "the pecuniary weight of the tax saving was so overwhelmingly greater than the benefit derived by the majority stockholders from the release of shares that it is difficult to believe that it was only the latter and never the former

to which they allowed their purposes to stray" (R. 95).^{*} The Tax Court's finding as to purpose, although couched in statutory language, in fact was not a finding that the purpose of preventing stockholders' surtaxes actually played a material or substantial part in causing the accumulations. When read in the light of the opinion, the finding was no more than a finding that petitioner had failed to prove the "complete lack" of the purpose penalized by Section 102, or that no "taint" of such a purpose existed.

The Circuit Court of Appeals stated that it could not "subscribe to the view (of the petitioner) that the prevention of the imposition of surtaxes must have been shown to have been the *dominant* factor behind the accumulations" (R. 374-5) without indicating the reason for or the bearing on this case of that conclusion. The Court overlooked the fact that the Tax Court had failed to find that the prevention of the imposition of surtaxes had been even a *substantial* factor behind the accumulations, but had proceeded on a wholly erroneous view of what the statute requires. The Circuit Court of Appeals did not purport to supply the lack of the finding as to purpose which was essential to liability, the absence of which it failed to recognize, nor would it have any authority or basis for doing so.

Both the Tax Court and the Circuit Court of Appeals misconceived the effect of the finding of an accumulation beyond the reasonable needs of the business and treated such finding as evidence of the existence of the purpose surviving the introduction of positive evidence of the actual purpose of the accumulation. Each seemed to proceed on the basis that to negative liability petitioner must disprove

^{*} On petitioner's computation, the theoretical tax saving was greatly overstated by the Tax Court—the figure for such saving being less than one-fourth of that used by it—while the benefits to the holders of restricted shares through release of the shares were greatly understated. (See pages 11-12 and 15-16, *supra*.)

such an accumulation, and failed to recognize that even though the Tax Court found that there was such an accumulation, no liability could attach if it was shown that the purpose of the accumulation was not that of preventing the imposition of surtaxes.

Questions Presented.

Petitioner does not base its request for a review by this Court on the ground that there was no substantial evidence to support the finding that profits were accumulated beyond the reasonable needs of the business, although the only direct evidence on the point was to the contrary, respondent did not produce a single witness to testify on this question of business judgment and petitioner regards that finding as incorrect. That finding is not decisive of surtax liability

The position of petitioner is that, notwithstanding the finding as to accumulation beyond reasonable business needs, the sustaining of liability in this case was based on vital errors.

The questions presented are:

1. Can corporate surtax liability be imposed on a corporation under section 102, Revenue Act of 1934, without a finding that the purpose of preventing the imposition of individual surtaxes on shareholders was a substantial factor in inducing the accumulations by the corporation? Upon the introduction of positive evidence as to the actual purposes of the accumulation, does not the *prima facie* effect given by section 102(b) to a finding of accumulation beyond reasonable business needs disappear from the case?

2. Did the Tax Court in the present case make a finding that the purpose of preventing the imposition of individual

surtaxes was a substantial factor in inducing the accumulations of the petitioner penalized by the Commissioner; and, would any such finding have been warranted?

Helvering v. National Grocery Co., 304 U. S. 282 (1938), and *Helvering v. Chicago Stock Yards Co.*, 318 U. S. 693 (1943), the only decisions of this Court dealing with this penalty surtax, do not support the decision below. In those cases the Court held on the facts that the condemned purpose was an inducing cause and liability was sustained, but the cases are clearly distinguishable on material facts.

In each of those cases there was much more than a mere accumulation of profits beyond reasonable needs, and the current payment of less surtaxes by stockholders than would have been payable had larger distributions been made. In each there was a single stockholder, and there were large loans to the sole stockholder. In each case it was specifically found that the purposes which were claimed to have motivated the accumulations could have been served equally as well by the accumulation of the funds in the hands of the sole stockholder as by the accumulation of the funds in the corporation.* Such is not the fact here.

In the present case, by contrast, no stockholder owned more than 23.5% of the stock, there were many hundreds of stockholders, no loans were made to stockholders, and

* "Mr. Prince, the sole stockholder, if in receipt of the respondent's earnings, could equally well have done what the respondent proposed to do, that is, turn accumulated earnings into invested capital." (*Helvering v. Chicago Stock Yards Co.*, 318 U. S. 693, 701-2.)

"Since Kohl was the sole owner of the corporation, the business would have been as well protected against unexpected demands for capital, and assured of capital for the purpose of any possible expansion, by his personal ownership of the securities as by the corporation's owning them. Moreover, no conceivable expansion could have utilized so large a surplus. The high taxes were first imposed in 1919. After that time no dividend was paid until after the close of the taxable year here involved." (*Helvering v. National Grocery Co.*, 304 U. S. 282, 294.)

the legitimate purposes of the controlling stockholders could be carried out only through building up *petitioner's* capital and income (which was accomplished notwithstanding the payment of substantial and increasing dividends from year to year) and which could not have been accomplished by accumulation of funds in the hands of the stockholders.

Moreover, in the two cases cited the stockholders merely denied the existence of the condemned purpose, without affirmative evidence of surrounding facts and circumstances to support their denial. Here the 1927 contracts constituted positive, forceful proof which dissolved the Government's *prima facie* case, leaving no basis for the finding of the existence of the condemned purpose.

Reasons Relied on for the Allowance of the Writ.

The decision below erroneously imposes liability under Section 102 of the Revenue Act of 1934 in the absence of a finding by the Tax Court that the avoidance of surtaxes on shareholders was a substantial factor inducing the accumulation of profits. This construction of the statute is inconsistent in principle with the decision of this Court in *United States v. Wells*, 283 U. S. 102 (1931), construing a statute imposing a tax on a transaction motivated by a particular purpose. The Court there held that transfers of property were subject to estate tax as made in contemplation of death only where the thought of death was the impelling, controlling, inducing or dominant motive of the transfer. (See further discussion of this case in petitioner's brief, page 29.)

The decision below erroneously applied subdivision (b) of Section 102 by treating the finding that profits were accumulated beyond the reasonable needs of the business as *prima facie* evidence of the existence of the condemned

purpose surviving the introduction by petitioner of evidence of the actual purpose inducing the accumulation. This conflicts in principle with the recent decision of the Circuit Court of Appeals for the 9th Circuit in *Hemphill Schools, Inc. v. Commissioner*, 137 F. 2d, 961 (1943).

The decision below erroneously imposes liability under Section 102 on an active manufacturing company, with widely held stock, where all that is found is accumulation beyond the reasonable needs of the business and the current payment of less surtaxes by stockholders than would have been paid had larger distributions been made, and where there was substantial, affirmative and undisputed evidence that the accumulation was motivated by purposes wholly unrelated to tax considerations. Under the decision below the *sole* defense against liability under Section 102 would be proof, satisfactory to the Tax Court, that no part of the corporate accumulation was beyond reasonable business needs. If reasonable men could differ on that question, a corporation could not safely accumulate profits even for business needs, and in no event could it accumulate for a non-business need, even though in the judgment of the directors the accumulations were essential, wise or necessary to accomplish some wholly legitimate purpose having nothing whatever to do with the avoidance of shareholders' surtaxes.

Furthermore, there could be no review of the Tax Court's decision in any case where there was any substantial evidence to support a finding of accumulation beyond reasonable business needs even though the taxpayer introduced overwhelming, persuasive and uncontradicted evidence that the actual purpose of the accumulation was wholly other than a purpose of preventing surtaxes. The tax would in effect become one on undistributed profits regardless of actual motive.

The Court below therefore decided an important question of Federal law, of far reaching importance and application, which has not been but should be settled by this Court.

The questions involved in this case are of unusual general importance at the present time because of the pressing need that business corporations retain adequate reserves for the post-war period, without risk of heavy penalties if the Commissioner and the Tax Court differ with the judgment of the directors. Under the decision directors of all business corporations will be under great pressure in every year of good earnings to distribute as dividends amounts which they in good faith believe should be retained to meet present and future needs. They will be apprehensive that the Commissioner of Internal Revenue, substituting his judgment for theirs, may hold that profits have been permitted to accumulate to some extent beyond the reasonable needs of the business, and may infer merely from that holding that a motive of surtax avoidance played some part in causing the accumulation, with the consequence of penalty surtaxes on the corporation under Section 102 and threat of personal liability on the directors for the action taken by them. They will be unable to rely on knowledge, however well founded, that accumulation is actually motivated by legitimate purposes wholly other than a purpose to avoid shareholder's surtaxes, as a defense against a penalty tax which by its terms is directed only against accumulations made for the purpose of avoiding surtaxes on shareholders.

It has already been found, through the costly experiment of the undistributed profits tax in effect for 1936 and 1937, that any statute thus causing business corporations to make unwise and unduly large distributions may have the most serious consequences in the future and seriously impair the ability of corporations to continue as fruitful income producers, taxpayers and employers of labor.

Taxpayers generally, the administrative officers and the Congress are entitled to know authoritatively whether the view of the law approved below is to prevail. In the *National Grocery* case this Court said "We granted certiorari because of the importance in the administration of the revenue laws of the matter presented" (304 U. S. 282, at 286), and in the *Chicago Stockyards* case a similar statement was made (318 U. S. 693, at 693-4). The construction of the statute as applied to corporations having but a single stockholder, as in those cases, is of far less general importance than its construction in the present case, where it was applied for the first time to an active business corporation having hundreds of stockholders, paying large dividends, and making no loans to stockholders. For the reasons pointed out above, business corporations generally need have no apprehension that the decisions in the *National Grocery* case and the *Chicago Stock Yard's* case may be applicable to them. The decision in the present case, however, raises new problems which vitally affect a wide range of ordinary business corporations with widespread stockholdings. The questions are of vital and general importance, particularly in view of post-war re-employment problems, and should be determined by this Court.

WHEREFORE, petitioner respectfully prays that a writ of certiorari issue under the seal of this Court to review the decision of the Circuit Court of Appeals for the Second Circuit in the above case, and that said decision be reversed.

TRICO PRODUCTS CORPORATION,
Petitioner.

By ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.

BRIEF IN SUPPORT OF PETITION.

Questions Presented, Statement of Case, etc.

The statement of questions presented, the statement of the case, and the statutes involved will be found in the petition.

Specification of Errors and Summary of Argument.

1. The Circuit Court of Appeals erred in construing section 102, Revenue Act of 1934, as imposing corporate surtax liability without a finding that the purpose of preventing the imposition of individual surtaxes on shareholders was a substantial factor in inducing accumulations by the corporation. Upon the introduction of positive evidence as to the actual purposes of the accumulation, the *prima facie* effect given by section 102(b) to a finding of accumulation beyond reasonable business needs disappears from the case.

2. The Circuit Court of Appeals erred in refusing to hold that the Tax Court in the present case made no finding that the purpose of preventing the imposition of individual surtaxes was a substantial factor in inducing the accumulations of the petitioner penalized by the Commissioner, and no such finding would have been warranted.

Argument.

Petitioner maintains that the lower courts erroneously construed Section 102 as imposing penal surtax liability if any "taint" of the condemned purpose existed, even though such purpose was not a substantial inducing cause of the accumulations of profits.

Petitioner did not attack any of the subsidiary findings of fact of the Tax Court. On appeal it did not argue that the finding that profits were accumulated beyond the reasonable needs of the business (R. 73) could not be treated as supported by substantial evidence, although believing such finding to be incorrect. What petitioner maintained, and maintains, is that such finding is not decisive of surtax liability under section 102.

Petitioner maintains that, because of the Tax Court's erroneous construction of the statute, its finding as to purpose, although couched in the language of the statute (R. 73) was not in fact a finding that the purpose of preventing the imposition of the surtax on shareholders was a substantial or inducing motive of petitioner's accumulations. Lacking a proper finding of the fact essential to liability, the Circuit Court of Appeals should have reversed the decision of the Tax Court. The lack of this essential finding as to purpose is not supplied by the finding that profits were accumulated beyond reasonable business needs, or the fact that greater distributions would necessarily have resulted in greater current surtaxes on shareholders. Those facts alone afford no basis for imposing liability where there is positive, uncontradicted testimony that the purposes inducing the accumulations were wholly other than a purpose of preventing surtaxes on shareholders.

I.

The Circuit Court of Appeals erred in construing Section 102, Revenue Act of 1934, as imposing corporate surtax liability in the absence of a finding that the purpose of preventing the imposition of individual surtaxes on shareholders was a substantial factor in inducing accumulations by the corporation. Upon the introduction of positive evidence as to the actual purposes of the accumulation, the *prima facie* effect given by Section 102(b) to a finding of accumulation beyond reasonable business needs disappears from the case.

Section 102 imposes liability only where the accumulation is "for the purpose of preventing the imposition of the surtax" upon the corporation's shareholders. This Court said in *Helvering v. National Grocery Co.*, 304 U. S. 282, 289 (1938), "The existence of the defined purpose is a condition precedent to the imposition of the tax liability
* * *."

Although the statute refers to "*the purpose*", petitioner does not contend that liability is conditioned on the condemned purpose being the *sole* purpose inducing the accumulation. Obviously, however, there must be a definite, substantial, causal connection between the purpose and the act. The mere fact that there is an accumulation and resulting payment currently by stockholders of less surtaxes is not sufficient. *Effect* must not be confused with *purpose*. Purpose is defined as "That which one sets before himself as an object to be attained; the end or aim to be kept in view in any plan, measure, exertion, or operation." (Webster's New International Dictionary, 2nd Ed.) By the plain terms of the statute liability is imposed only if the purpose of preventing the

imposition of surtaxes on shareholders was the inducing cause of the accumulations. No other test of liability is prescribed by Section 102.

Where more than one purpose may to some measure operate, the extent to which the purpose specified as a basis for tax liability must come into play is indicated by the decision of this Court in *United States v. Wells*, 283, U. S. 102 (1931), which also involved a tax statute making liability dependent on the purpose or state of mind of a person. The statute there construed (now Section 811(c) of the Internal Revenue Code) included in the gross estate of a decedent, for purposes of taxation, any property "of which the decedent has at any time made a transfer * * * in contemplation of * * * death." This Court stated that "The question, necessarily, is as to the state of mind of the donor" (p. 117), and that "the words 'in contemplation of death' mean that the thought of death is the impelling cause of the transfer * * *" (p. 118). The Court referred to the motive or purpose required for liability as "a controlling motive" (p. 118) or "inducing cause" (p. 119). It said the gratification of desires associated with life "may be a more compelling motive than any thought of death", and concluded (p. 119):

"There is no escape from the necessity of carefully scrutinizing the circumstances of each case to detect the dominant motive of the donor in the light of his bodily and mental condition, and thus give effect to the manifest purpose of the statute."

In *Farmers' Loan & Trust Co. v. Bowers*, 98 F. (2d) 794 (C. C. A. 2d, 1938), certiorari denied 306 U. S. 648, the Circuit Court of Appeals held that whether or not the desire to avoid estate taxes had to be the dominant or controlling motive, it was at least necessary that the death

motive be important and substantial. It affirmed the District Court's decision because "the evidence demonstrated that avoidance of estate taxes was a substantial motive for the settlor's action." See Paul, *Estate and Gift Taxation*, Sections 6.07 to 6.14.

The phrase "in contemplation" in Section 811(c) of the Internal Revenue Code is not as strong as the phrase "for the purpose" in Section 102 of the Revenue Act. Since in the case of the former the death motive must be the "inducing," "impelling," or "controlling" cause of the transfer, it seems clear that in the case of the latter the avoidance of surtaxes must also be the inducing, compelling or controlling cause of the accumulation of profits. It would not appear that this Court, in its opinion in the *Chicago Stockyards* case, *supra*, intended to lay down any different principle with respect to Section 102 when it said (p. 699):

"A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulation was adopted, the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice."

This would seem to mean merely that a practice originally instituted without regard to the condemned purpose may be found to have been continued because of the coming into play of that purpose. It affirms that there must be a causal connection between the condemned purpose and the act. It is submitted that if the measure of that connection is not dominance, as laid down in the *Wells* case, the specified

purpose must at the very least be a material or substantial cause of the action taken.

The construction of the statute adopted in the decision below (See pp. 18-19 *supra*) is clearly inconsistent in principle with the decision in the *Wells* case. If liability can be imposed only if the purpose specified in the statute is the *dominant* purpose, as the *Wells* case indicates, the holding of the Circuit Court of Appeals is in direct conflict with the *Wells* case. Even if the purpose specified need be merely a substantial inducing cause, though not dominant, the construction of the statute adopted below is wrong because not even this minimum causal connection is required under the Tax Court's erroneous construction of the statute which the Circuit Court of Appeals refused to correct.

Subdivision (b) of Section 102 does not have the effect of authorizing the imposition of liability without a finding that the purpose specified in the statute was a substantial cause of the accumulations, where the taxpayer goes forward with the evidence and shows that the impelling motive was other than that of avoiding surtaxes on shareholders. Subdivision (b) of Section 102 provides:

"The fact * * * that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax."

Under this provision, accumulation beyond reasonable business needs, if *unexplained*, can be treated as the basis of liability—this not because proven facts actually establish the existence of the condemned purpose, but merely because of the failure of those who know the facts to introduce evidence establishing the actual purpose. Wigmore on Evidence (3rd Ed., 1940) Sec. 1356. The mere fact of accumulation beyond reasonable business needs does not

logically tend to prove that the purpose of the accumulation was that of avoiding surtaxes, and in no way negatives the impelling force of a wholly different purpose. This fact gives equal support to inconsistent inferences and does not prove *why* the accumulations were made.

Section 102(b) creates a purely artificial statutory nexus between the two facts. When evidence is introduced as to the actual purpose inducing the accumulation, the statutory presumption that accumulation beyond reasonable needs is *prima facie* evidence of the existence of the condemned purpose disappears as completely as if it had never existed. Wigmore on Evidence (3rd Ed., 1940) Sec. 2491, *Mobile, J. & K. C. R. R. v. Turnipseed*, 219 U. S. 35, 43 (1910); *Western & Atlantic Railroad v. Henderson*, 279 U. S. 639 (1929); *Griffin v. The State*, 142 Ga. 636, 639 (1914).

Hemphill Schools, Inc. v. Commissioner, 137 F. (2d) 961 (C. C. A. 9th, 1943), shows the limited effect of artificial presumptions. In that case, which arose under Section 102, the sole issue was whether there had been an accumulation beyond the reasonable needs of the business, the taxpayer making no contention that there were other legitimate reasons for the accumulation. The Circuit Court of Appeals reversed the Tax Court for having given weight as evidence to the presumption of the correctness of the determination of the Commissioner on that issue, after affirmative evidence had been introduced by the taxpayer. The Court said:

“Thus, if no evidence had had been produced, the Board would have had to accept the determination; for, until evidence was produced, the determination was presumed to be correct [citing cases].

“Evidence *was* produced. Some of the evidence produced by petitioner tended to prove that its gains

and profits were not permitted to accumulate beyond the reasonable needs of its business. Evidence having been so produced, the presumption ceased, and thenceforth the issue depended 'wholly upon the evidence' [citing cases]. It thus became the duty of the Board to find from the evidence, and from it alone, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the presumption (which no longer existed) as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it."

Petitioner concedes that the *prima facie* evidence is not dissolved by a mere categorical denial of the existence of the condemned purpose. Where, however, the taxpayer introduces affirmative, forceful and undisputed evidence of an actual purpose wholly different from the prevention of individual surtaxes on shareholders, it is submitted that this evidence must be controlling, in the absence of affirmative evidence (as distinguished from the artificial presumption) to the contrary.

The lower courts did not so apply the provision of Section 102(b). The Tax Court said "The *prima facie* case is an affirmative one created in respondent's favor" (R. 89). The Circuit Court of Appeals apparently also regarded the statutory presumption as evidence to be weighed by the Tax Court in reaching its conclusion (R. 374). The clear implication is that where in the judgment of the Tax Court earnings are accumulated beyond reasonable business needs, the Tax Court, because of the statutory presumption, need not find from the evidence that the purpose specified in the statute motivated the accumulations, but can impose liability, no matter what motives or purposes are actually proved, unless convinced that the pur-

pose specified in the statute was wholly and completely absent.

Such a view misconceives the effect of subdivision (b) of Section 102 and conflicts in principle with the decision of the Circuit Court of Appeals for the 9th Circuit in the *Hemphill Schools, Inc.* case, *supra*. Section 102 (b) does not authorize the imposition of the tax merely because of an accumulation beyond reasonable business needs where the taxpayer comes forward with affirmative evidence that the impelling motive was wholly other than that of surtax avoidance.

The view of the courts below would substantially convert the tax under Section 102 into an entirely different tax imposed on accumulation of profits beyond the reasonable needs of the business, regardless of purpose. Congress might have imposed a tax on accumulations of profits beyond the reasonable needs of the corporation's business, or it might even have imposed a tax on total accumulations if any part thereof was beyond reasonable business needs, but it is clear that it did not do so in Section 102. This tax is limited to "corporations *improperly* accumulating surplus," the impropriety justifying imposition of the tax being an accumulation "for the purpose of preventing the imposition of the surtax upon its shareholders * * *."

The tax under Section 102, being dependent on purpose, differs radically in nature from the *undistributed profits* tax imposed by Section 14, Revenue Act of 1936, the tax which caused the petitioner to divert from its established dividend practice and declare extra dividends in 1936 and 1937. Unlike the tax under Section 102, that tax was measured by undistributed income at rates ranging up to 27%, without regard to the purpose of the accumulations. The Revenue Act of 1936 also continued in effect the penalty surtax under Section 102 (the same tax as that here in-

involved), with a rate reduction of 10% to corporations held to be subject to both taxes (Section 102(a)(1) and (2)). Since both provisions were in the 1936 Act, it is apparent that their purpose and incidence were different. *U. S. v. Hutcheson*, 312 U. S. 219 (1941).

The tax on *undistributed profits*, first imposed by the Revenue Act of 1936, met with widespread protest. This led to the virtual abandonment of such a tax in Section 13, Revenue Act of 1938. The last vestige was eliminated by Section 201, Revenue Act of 1939.

It could not possibly have been the intention of Congress that Section 102, which was continued in effect throughout this period, should be applied for all practical purposes as if it were the different and later repealed tax imposed on *undistributed profits*, irrespective of purpose. Yet that is precisely the result of the decision below. Under that decision the statute is applied as follows: First, the Tax Court, substituting its judgment for that of the directors, makes a finding that there was an accumulation beyond the reasonable needs of the business. This finding is virtually non-reviewable, inasmuch as in every such case the record will contain balance sheets, income statements and the like which might be deemed "some evidence". Second, even though the taxpayer comes forward with evidence as to the actual purposes of the accumulation, the Tax Court is permitted to make a finding of the condemned purpose *merely on the basis of the accumulation itself*, without any determination on the affirmative evidence that the accumulation was actually motivated by surtax considerations. Thus, under the decision below, a fact which Congress carefully provided should be but *prima facie* evidence, putting on the taxpayer merely the burden of going forward with evidence to the contrary, is made practically conclusive of liability.

Under this construction of the statute the only safe procedure which directors can follow is to distribute earnings to a point where reasonable men cannot differ as to the necessity for keeping the remainder in the business. Accumulation of any greater amount cannot safely be made even though in the judgment of the directors it is desirable for the business. No accumulation can safely be made for the purpose of protecting rights of stockholders under perfectly legitimate contracts, or for any legitimate purpose other than business needs. Obviously proof of actual purposes cannot be relied upon as a defense if the Tax Court is to be permitted to find the existence of the condemned purpose on the basis of *prima facie* evidence even after the taxpayer has produced affirmative, undisputed evidence as to the actual purposes.

The decision below was thus based on fundamental errors of law in the construction and application of the statute, conflicting in principle with decisions of this Court and should therefore be reviewed by this Court.

II.

The Circuit Court of Appeals erred in refusing to hold that the Tax Court in the present case made no finding that the purpose of preventing the imposition of individual surtaxes was a substantial factor in inducing the accumulations by the petitioner penalized by the Commissioner, and no such finding would have been warranted.

The Tax Court in this case purported to find the ultimate fact as to purpose, essential to liability, that "petitioner was availed of for the purpose of preventing the imposition of

the surtax on its shareholders" (R. 73, 97). This finding, however, must be read in the light of the statements in its opinion (quoted, *supra*, p. 18). From these it clearly appears that the Tax Court erroneously believed that the statute authorized such a finding if there was "any taint of a purpose" to avoid surtaxes, or if the stockholders "allowed their purposes to stray" in that direction. The Tax Court believed that the taxpayer must show "complete innocence" and a "complete lack" and "absence" of the condemned purpose.

The Tax Court's finding, thus read in the light of its opinion, was not a finding that the condemned motive actually played a material or substantial part in causing the accumulations, or was an inducing or contributing cause, or that but for a purpose to avoid surtaxes petitioner in 1934 and 1935 would have changed the dividend policy it had theretofore followed from 1928 to 1933, without question by the Commissioner, and would have made greater distributions. The fact which the Tax Court regarded as supported by the preponderance of the evidence wholly apart from presumptions and burden of proof (R. 97), namely, that there was a "taint" and not a "complete lack" of a purpose to avoid surtaxes, was not the fact giving rise to liability under a proper construction of the statute.

Petitioner does not by any means concede that there was even a "taint" of the condemned purpose. Petitioner submits, however, that that is all the Tax Court actually found; that the finding essential for liability was that the condemned purpose played a material or substantial part in causing the accumulations; and that since the Tax Court omitted to make the finding required, the Circuit Court of

Appeals was not free to affirm the decision unless the omitted finding was compelled by the evidence. The Circuit Court of Appeals did not and could not on the record hold that there was any such compelling evidence.

The lack of a proper finding as to purpose, essential to liability under the statute, is not overcome by the Tax Court's finding in the present case of an accumulation beyond the reasonable needs of the business. Petitioner did not, on appeal, challenge that finding, although believing it to be unwarranted. That finding, however, merely required petitioner to go forward with the evidence and show affirmatively the purposes motivating the accumulations. This the petitioner did. Thereupon the *prima facie* effect of that finding as proof of purpose completely disappeared from the case.

The evidence before the Tax Court did not compel, and in fact would not warrant, a finding that a purpose of preventing the imposition of surtaxes on shareholders was a substantial or inducing cause of petitioner's dividend policy.

The evidence shows that in connection with the arm-length sale of stock in 1927 the stockholders, at the instance of the bankers, agreed with the Company to "waive" dividends up to \$2.50 per share on 450,000 shares of stock. The bankers agreed to the provisions of the contract giving the stockholders the right to release the restricted shares from this waiver because they realized that such release could be effected only through the "conservation of earnings" and the building up of corporate earning power, and that this would protect and enhance the value of the shares they were selling to the public.

The 1927 contract did not expressly provide that no dividends (in addition to the annual dividend of \$2.50 per share on the free shares) should be paid until the book value of the stock had been built up, but the inducement of obtaining

release of the restricted shares was calculated to have such an effect. The bankers knew who would control the dividend policy of the Company—they knew that the principal holders of the restricted shares would be the directors. They knew it would be in the interest of those directors to conserve the corporate assets and earnings so as to effect a release of the restricted shares. They relied on this motive rather than on an express provision in the contract restricting dividends.

Neither did the 1927 contract expressly provide that no dividend (in addition to the annual dividend of \$2.50 a share on the free shares contemplated thereby) should be paid until all the restricted shares were released. The bankers, acting in the interest of the free stock, knew that the controlling stockholders would have a very strong inducement to limit dividends to \$2.50 per share on the free shares and thereby increase the earnings of the Company to the levels necessary to release the restricted shares as rapidly as possible. They knew that, in the absence of unforeseen circumstances, the directors would never depart from such a policy.*

All the parties to the 1927 transaction realized that the Company's earnings could not be built up to the release levels of \$5, or \$6, or, eventually, \$9 a share except by "conservation of earnings and working capital." They believed that the stipulated levels of earnings could be reached, but the Company concededly could not make any such profits on

* The enactment of the undistributed profits tax (Section 14, Revenue Act of 1936) was an unforeseen circumstance which, in 1936 and 1937, diverted petitioner from its fixed dividend practice to the extent that additional distributions of \$1.37½ per share were made on all stock outstanding (R. 57). This does not support an inference that petitioner's dividend practice was not actuated by the purpose of carrying out the 1927 contracts. That purpose would have been frustrated either by permitting the undistributed profits tax to be imposed or by making the extra distributions to stockholders, thus leaving no real choice but to make the extra distributions.

the capital it had in 1927. The only way in which it could increase its earnings to such levels was by keeping the earnings in excess of \$2.50 a free share and (a) using as much as was practicable as additional working capital in the growing manufacturing business and (b) investing the remainder in securities, pending its absorption by the business, and adding the income from such investments to operating profits. The Company could not add to its capital except by accumulating earnings because it had agreed not to make any change in its capitalization until all its restricted shares were released. Under the contract, it could not put out an additional issue of stock (R. 282).

Under this set-up the controlling stockholders had the strongest possible motives, wholly independent of surtax considerations and entirely in accord with the welfare of the corporation, to follow the dividend practice which was established upon the recapitalization and sale of stock, was adhered to thereafter through 1933 without objection from the Commissioner, and was continued during the tax years in question. In view of these inducements it is clear that the practice which was followed was exactly the practice which would have been followed if there were no surtaxes at all on dividends to stockholders; that the corporation was not diverted by surtax considerations in the conduct of its affairs; and that the Government was not, because of consideration of stockholders' surtaxes, deprived of revenue which it otherwise would have received. In fact its tax revenues from the original stockholders were steadily increased as additional shares were released.

The Tax Court failed to give proper consideration to the over-all results, tax-wise, of the policy pursued. As indicating the purpose of that policy, its effect in any particular year must be viewed against the broader picture of

the entire operation. As the heading of the statute states, the penalty is imposed on "Corporations *Improperly Accumulating Surplus*." The impropriety rests in accumulations made to avoid "the surtax" on shareholders. This does not necessarily refer to the surtax for the current year, but to a course of conduct designed over a period to escape the impact of the system of surtaxes at progressive rates, by leaving in the corporation amounts which but for the surtax burden would normally have been distributed.

In the present case the dividends received by the old stockholders, and the surtaxes paid by them, steadily increased from year to year under the policy pursued (see pp. 14-16, *supra*). Those in control were using their best efforts and judgment to increase both corporate income and their individual incomes. Their efforts were highly successful. The Government shared greatly in their success through increased corporation and individual taxes. The results could not have been achieved if the Company had ceased to grow after 1927, or after 1933.

In summary, it is submitted that the uncontradicted evidence showed that the prevention of surtaxes on shareholders was not a "purpose" of the accumulations within the meaning of the statute. The saving of surtaxes was not, to paraphrase the definition of the word purpose, "that which the stockholders set before themselves as an object to be attained"; it was not "the end or aim kept in view in the plan of operation."

Petitioner's evidence was, of course, directed partly to the question whether the accumulations were beyond the reasonable needs of the business. To a very large degree, however, the evidence was intended to show, and did show, that irrespective of the reasonable needs of the business, the purposes of these accumulations were wholly legitimate and had no relation to surtax considerations.

The Tax Court nevertheless attempted to dispose of petitioner's evidence simply on the ground that it did not prove that the accumulations were for business needs. It completely confused the question whether there had been an accumulation beyond the reasonable needs of the business with the entirely different question as to whether or not the accumulation was made for the condemned purpose.

Similarly, the Circuit Court of Appeals referred to a number of contentions which petitioner had made before the Tax Court, including the contention that petitioner's purpose was "to enable it to meet the conditions for freeing its remaining restricted stock and the like," and stated that the Tax Court "having weighed all that against the position of the treasury that the accumulations were in excess of reasonable business needs concluded that the latter was correct" (R. 374). Here the court apparently held that the accumulation was conclusive as to purpose, even in the face of evidence completely eliminating the statutory presumption. In any event, the Circuit Court of Appeals stated that in view of "the limited scope of our power to review" it would not change the result. It did not purport to supply or dispense with the finding of fact as to purpose, essential to liability, but it failed to recognize the lack of such finding.

The Tax Court stated, and the Circuit Court of Appeals apparently concurred, that the course adopted "may have been a natural course for the majority of the stockholders to cause the corporation to adopt for their own private ends * * *" (R. 95). This being true, no liability under Section 102 was incurred, unless this course of conduct was shown to have been adopted for the condemned purpose specifically defined in the statute. Petitioner was not required under the statute to establish that the accu-

mulations were for business needs, but only that they were not motivated by surtax considerations. This the petitioner did establish, by uncontradicted and convincing proof.

The evidence before the Tax Court thus would not have supported a finding that a purpose of preventing the imposition of surtaxes on shareholders was a substantial or inducing cause of petitioner's dividend practice, even if such a finding had been made. Certainly the evidence did not compel such a finding, for it affirmatively established that the actual purposes were wholly other than avoidance of surtaxes.

The general importance of the questions presented in this case in the administration and effect of the revenue laws is apparent from the implications of the decisions below. In the first place, under the decisions the Commissioner and the Tax Court are not required to determine that the condemned purpose was an inducing, or even a contributing, cause of the accumulations, but need do no more than infer that the condemned purpose was not completely lacking. In the second place, the decision dispenses with any actual proof whatever of the condemned purpose, the Commissioner and the Tax Court being permitted to infer the existence of this absolutely indispensable fact merely from their own conclusion on the evidence as to accumulation beyond reasonable needs of the corporation and in the face of affirmative evidence to the contrary. By combining these two theories, every corporation is placed in jeopardy, and subjected to the risk of very heavy penalties in every case where there is room for difference of opinion as to the reasonable present and future needs of the business. Under the decision, knowledge on the part of directors, however well founded, that accumulation is

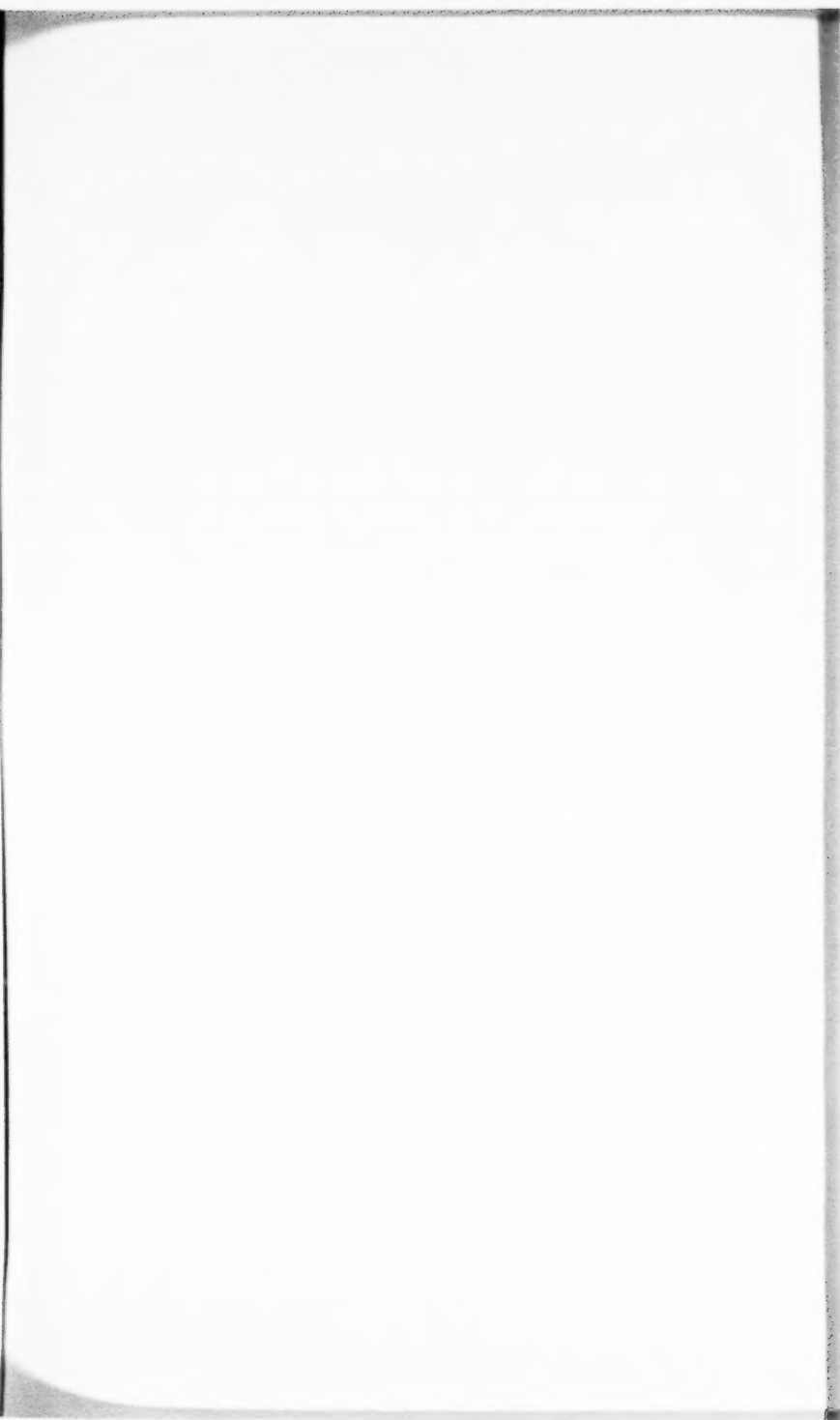
not motivated by surtax avoidance considerations and is motivated wholly by other legitimate purposes, is no defense to liability for a penal tax which by its terms is based solely on the existence of the surtax avoidance motive. The result is to substitute for the statutory test of liability a radically different one, vastly extending the liability, and pregnant with disastrous economic consequences.

Conclusion.

For the foregoing reasons it is respectfully submitted that the petition for writ of certiorari to the Circuit Court of Appeals for the Second Circuit should be granted.

Respectfully,

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.





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No. 400

FILED

DEC 7 1943

CHARLES ALMOND BRIDLEY
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1943

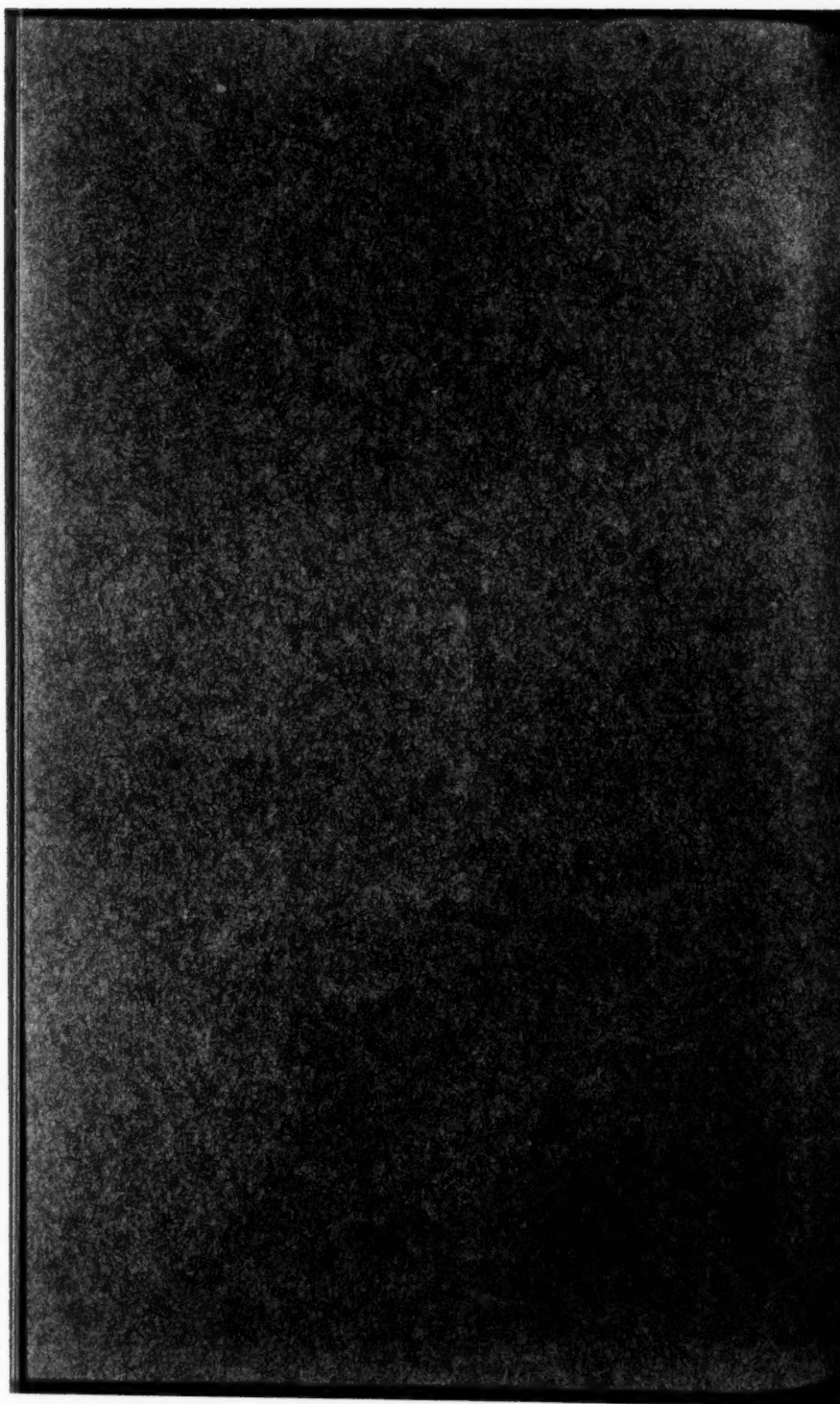
TRICO PRODUCTS CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

**ON PETITION FOR A WRIT OF HABEAS CORPUS TO REMOVED
STATE CIRCUIT COURT ON APPEAL FROM THE
CIRCUIT**

BRING FOR THE RECORDS OF THE CIRCUIT



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(1)



In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 490

TRICO PRODUCTS CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 46-104) is reported in 46 B. T. A. 346. The opinion of the Circuit Court of Appeals (R. 370-375) is reported in 137 F. 2d 424.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on August 19, 1943 (R. 390), following denial of a petition for rehearing on August 18, 1943 (R. 387). The petition for a writ of certiorari was filed on November 16, 1943. The jurisdiction of this Court is invoked under Sec-

tion 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether, notwithstanding the taxpayer's denials, there was substantial evidence to support the determination of the Board of Tax Appeals that during the years 1934 and 1935 the taxpayer's earnings were permitted to accumulate, instead of being distributed, in order to avoid surtaxes upon its shareholders.

2. Whether the Board of Tax Appeals erred (a) by failing to make an express finding that the purpose of avoiding surtaxes was a substantial factor inducing the taxpayer's accumulation of earnings, or (b) by misapplying the presumption established by subdivision (b) of Section 102 of the Revenue Act of 1934.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 17-21.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 47-73) may be summarized as follows:

The taxpayer was incorporated in 1920 under the laws of the State of New York. Its principal activities had been the manufacture and sale of automatic windshield wipers in Buffalo. It was organized to take over the assets and business of a former company organized by the same

stockholders in 1917, which had been engaged primarily in making hand-operated windshield wipers. Between 1920 and 1927 the business grew and further capital was put into the company from time to time by the stockholders, who personally borrowed money and bought the company's stock. An automatic windshield wiper was developed in 1921 which was the foundation of the taxpayer's subsequent success and prosperity. (R. 47.)

The windshield wiper device was covered by patents, of which the principal ones were owned prior to October 1927 by John R. Oishei, the president and general manager of the company. The basic patents expired in 1942. In 1927 the taxpayer had about 100 patents. It has always sought improvements, and has approximately 600 additional patents, most of which are related to windshield wipers, and which extended beyond 1942. (R. 48.)

After 1931 the taxpayer supplied 100 per cent of the total automatic windshield wiper requirements of all automobile production in the United States and Canada. During the period 1937 to 1939, inclusive, its percentage of net profits to net sales ranged from 27.1 to 32.7. Increased sales have always resulted in increased profits in the taxpayer's business. (R. 67.) Most of taxpayer's sales were to General Motors, Chrysler, and Ford, which took about 75 to 80 per cent of taxpayer's output (R. 68). The market for taxpayer's pres-

ent products has been controlled entirely by automobile production (R. 69). Since 1927 the taxpayer has owned the patent for the automatic windshield wiper, which was the principal source of its earning power and gave it its monopoly (R. 70).

During the taxable year 1934 the taxpayer's net earnings were \$1,771,558, of which \$937,485.62 was distributed in dividends; during the taxable year 1935 the taxpayer's earnings were \$3,567,404, of which \$925,322.70 was distributed in dividends (R. 58, 61). On December 31, 1933, at the beginning of the taxable period, the taxpayer's accumulated gains and profits were "not less" than \$5,252,534.99. On December 31, 1935, at the end of the taxable period here involved, the taxpayer's accumulated gains and profits were not less than \$8,762,708.19. By December 31, 1939, they had arisen to not less than \$17,116,605.36. (R. 58.) The taxpayer's investments in securities, consisting principally of Government bonds and stocks of other corporations, amounted to \$1,097,571.40 at the end of 1929. They were \$4,026,952.38 at the end of 1933; \$6,859,067.96 at the end of 1935; and \$11,353,779.10 at the end of 1939. (R. 59.)

In 1927, prior to a reorganization in October of that year, the taxpayer's capital stock consisted of 8,000 shares of common. It had 21 stockholders who were in general the same group which organized the taxpayer in 1920 and had been

associated with John R. Oishei prior to that time.¹ (R. 48.)

In the summer of 1927 some bankers proposed a recapitalization of the taxpayer (R. 49). Instead of 8,000 shares, there were to be 675,000 shares, without par value (R. 50). The bankers agreed to purchase 175,000 shares for \$4,225,000 in cash, which was to be ratably distributed among the stockholders (R. 50-51). Of the remaining 500,000 shares, 450,000 shares were not to be entitled to dividends, unless the dividends exceeded \$2.50 per share in any one year, and until the earnings reached certain limits (R. 51-52).

The syndicate agreement provided for the release of restricted shares as free shares in the following terms (R. 51-52):

It is agreed that commencing January 1, 1928, up to 112,500 deferred shares may be exchanged for free shares accordingly as net earnings of the Company for the calendar year 1927 or for any year thereafter shall be equal to \$5 per share upon the sum of the free shares then outstanding plus the number of free shares required for such exchange and in like manner commencing January 1, 1929 additional deferred shares up to 112,500 may be exchanged accordingly as the net earnings

¹ From 1920 until the date of the taxpayer's reorganization in 1927 John R. Oishei and Peter C. Cornell, together, owned more than 50 percent of the taxpayer's stock (R. 298).

of the Company for the calendar year 1928 or for any year thereafter are equal to \$6 per share on the sum of the free shares plus the free shares required upon such exchange and in like manner the remaining 225,000 deferred shares may be exchanged accordingly as the net earnings of the Company for the calendar year 1929 or for any year thereafter are equal to \$9 per share on the sum of the then outstanding free shares plus free shares required upon such exchange; provided that as condition precedent to such exchange in 1928, dividends at the rate of \$2.50 per share shall have been paid on the free shares from date of issuance and provided that at the date of each successive exchange herein provided for, dividends aggregating \$2.50 shall have been declared and paid during the then next preceding twelve months upon the free shares then outstanding.²

² The formula according to which the restricted stock was to be released under the contract between the original stockholders and the bankers is substantially as follows (R. 51-52, 61) :

Number of shares (from group of 450,000 to be released)	Date	Earnings necessary to release first share	Earnings necessary to release last share
112,500.....	Beginning January 1, 1928.....	\$1, 125, 005	\$1, 687, 500
112,500.....	Beginning January 1, 1929.....	2, 025, 006	2, 700, 000
225,000.....	Beginning December 31, 1929.....	4, 050, 009	6, 075, 000

The 450,000 restricted shares were to be placed in a voting trust under the agreement with the bankers (R. 50). The trustees of the voting trust were John R. Oishei, Peter C. Cornell, S. H. Evans, and William P. Haines. The stockholders who entered into this agreement were the above-named trustees and Ieuan Harris and B. F. Oishei. (R. 53.) The original stockholders also retained 50,000 shares of free stock (R. 55).

In 1929 Trico Securities Corporation³ was organized to take the place of the voting trust and

The number of restricted shares released in the respective years resulting from the application of the formula to the earnings is as follows (R. 61) :

Year	Earnings	Shares re-released after close of year	Total shares released in each group per formula
1927	\$1,372,303	49,460	112,500
1928	1,778,475	63,040	
1929	2,249,947	37,491	
1930	1,908,415	None	
1931	1,762,550	None	
1932	964,964	None	
1933	1,418,277	None	
1934	1,771,558	None	112,500
1935	3,567,404	75,009	
1936	4,184,560	14,951	14,951
1937	3,792,244	None	
1938	2,319,854	None	
1939	3,540,669	None	
Total shares released		289,951	

³ The *Trico Securities Corp. v. Commissioner*, 41 B. T. A. 306, in which it was held that that corporation was not formed or availed of for the condemned purpose under Section 104 of the Revenue Act of 1932. The taxable year was 1933. No

acquired all of the then restricted stock amounting to 337,500 shares from the original stockholders, who became stockholders of Trico Securities Corporation in proportion to their holdings of the restricted shares ⁴ (R. 56).

The total number of shares, free and restricted, held by Trico Securities Corporation during the years 1929 to 1937 is as follows (R. 56-57):

	Restricted shares	Free shares	Total
December 31, 1929.....	337,500		337,500
December 31, 1930.....	300,009	60,601	360,610
December 31, 1934.....	300,009	57,269	357,269
December 31, 1935.....	300,009	57,269	357,269
December 31, 1936.....	225,000	132,269	357,269
December 31, 1937.....	210,049	147,220	⁵ 357,269

Each release of restricted stock has increased the dividend participation of the original stockholders. When and if all restricted shares are

appeal was taken by the Commissioner, presumably in the view that there was substantial evidence to support the Board's decision.

⁴ John R. Oishei and Peter C. Cornell together held more than 50 percent of the stock in Trico Securities Corporation during the period from 1930 through 1937 (R. 355).

⁵ Since the taxpayer had 675,000 shares of stock outstanding, it will be seen that Trico Securities held 50 percent of taxpayer's stock in 1929 and more than 50 percent in the years 1930 through the taxable years. Therefore, John R. Oishei and Peter C. Cornell, through their control of Trico Securities, effectively controlled the taxpayer during the period from 1930 through 1937. In addition to their holdings in Trico Securities, they held substantial amounts of taxpayer's free shares in the period from 1929 through 1935 (R. 363-364).

released, the original stockholders will receive approximately 75 percent of all dividends distributed. The taxpayer had some 1,500 stockholders in 1928, after the bankers had sold stock to the public, and their number had increased to about 2,200 in 1935. (R. 57.)

At the time of the reorganization and sale of stock to the bankers in 1927 the bankers required that taxpayer obtain title to the patents used by the corporation then owned by John R. Oishei, which include the basic patent on the automatic windshield wiper. They accomplished this by giving John R. Oishei a profit-sharing agreement. The payments to John R. Oishei under the agreement were charged to expense. Those payments amounted to about \$379,000 in 1934, and about \$649,000 in 1935. (R. 70.)

All of the large individual stockholders of taxpayer were in the taxable years, and for several years prior thereto, men of substantial wealth. They had large incomes each year on which they paid federal income taxes. They knew, in general, that the tax rate increased as income increased, and that if additional distributions of dividends had been made by petitioner during the taxable years they would have had to pay more federal surtaxes. (R. 72.)

The surtaxes avoided by the following stockholders by reason of the failure of taxpayer to distribute the undistributed portion of its net book income are as follows (R. 72):

	Surtax avoided, 1934	Surtax avoided, 1935
Trico Securities Corporation.....	\$53,978.54	\$433,417.28
John R. Oishei.....	29,419.45	97,346.23
Peter C. Cornell.....	28,654.78	93,825.40
S. H. Evans.....	6,128.65	30,706.80
Ieuan Harris.....	15,968.00	53,145.46
W. J. Chelley.....	367.07	1,245.47
Total.....	134,516.49	709,686.82

At the close of 1934 and 1935 the above six stockholders owned nearly 74 percent of the outstanding capital stock of taxpayer. By reason of purchases by taxpayer of treasury stock from the public the holdings of these stockholders had increased to approximately 78 percent at the close of 1937. (R. 73.)

Had taxpayer distributed the undistributed portion of its net book income and had the share so received by Trico Securities Corporation been distributed by it, the additional surtaxes payable by the stockholders indicated below would be as follows (R. 73):

	Additional surtax	
	1934	1935
John R. Oishei.....	\$108,720.03	\$356,734.85
Peter C. Cornell.....	97,924.94	322,260.16
S. H. Evans.....	35,166.41	134,590.02
Ieuan Harris.....	19,981.40	65,878.65
C. H. Oishei.....	12,008.17	69,071.52
W. J. Chelley.....	1,754.45	7,455.37
Total.....	275,564.40	955,999.57

The above six stockholders during the taxable years owned approximately 87 percent of the outstanding capital stock of Trico Securities Corporation. Together with the other few original stockholders or relatives they owned approximately 100 percent (R. 73).

During the taxable years taxpayer permitted its gains and profits to accumulate beyond the reasonable needs of its business (R. 73).

During the taxable years taxpayer was availed of for the purpose of preventing the imposition of the surtax upon its shareholders, and the shareholders of another corporation, through the medium of permitting its gains and profits to accumulate instead of being divided or distributed (R. 73).

Pursuant to the findings, the Board sustained the Commissioner's determination that the corporation had been availed of in the taxable years 1934 and 1935 for the purpose of preventing the imposition of surtaxes upon its stockholders. The Circuit Court of Appeals affirmed the decision.

ARGUMENT

1. The decision of the court below is correct. Section 102 of the Revenue Act of 1934 (Appendix, *infra*) provides for the levy of a substantial tax on the "adjusted net income" of a corporation,⁶ if such corporation is availed of for the pur-

⁶ Under the earlier Revenue Acts the tax was levied on the *net income* of the corporation. The 1934 Act made allow-

pose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed. In cases arising under this section the Board's determination is conclusive if supported by substantial evidence. *Helvering v. Stock Yards Co.*, 318 U. S. 693; *Helvering v. Nat. Grocery Co.*, 304 U. S. 282. Since the Board of Tax Appeals decided in this case that the corporation was availed of for the condemned purpose, the only factual question before the court below was whether there was substantial support for the Board's determination.

The Board's detailed findings clearly support its ultimate determination under Section 102, as well as under Article 102 of Treasury Regulations 86 (Appendix, *infra*). The taxpayer, indeed, does not dispute the finding that the taxpayer's earnings were permitted to accumulate beyond the reasonable needs of the business (Pet. 20; Br. 27).⁷ Although on the surface the tax-

ance for any dividends distributed, which were to be deducted from the corporation's net income. The balance was called "adjusted net income." See subsection (c) of Section 102. See also subsection (d) of Section 102 which provides a method whereby stockholders may avoid application of Section 102 to their corporation by paying their pro rata share, whether distributed or not, of the corporation's "adjusted net income."

⁷ By Section 102 (b), this fact is declared to be "prima facie evidence of a purpose to avoid surtax." Quite apart from Section 102 (b), and any questions which might be

payer's stock was "widely held" (Pet. 23), the corporation was controlled by a small group of wealthy men, who profited heavily by the taxpayer's failure to pay out its earnings in dividends. The Board heard and considered the evidence introduced to explain the accumulations on a ground unrelated to tax considerations, but concluded that "there is an absence of conviction" in these explanations (R. 97). Obviously, the Board was not required to accept the taxpayer's denials at face value and thus abdicate its position as the trier of the facts. See *Helvering v. Stock Yards Co.*, *supra*; *Helvering v. Nat. Grocery Co.*, *supra*. The Circuit Court of Appeals gave the taxpayer the full review of the Board's determination to which it is entitled, and concluded (R. 374) that—

The result reached by that tribunal was certainly a reasonable one arrived at with due regard for the right of the parties to be heard fully and fairly upon all relevant issues.

Accordingly, there is no occasion for further review here.

2. The taxpayer contends that a proper construction of Section 102 requires a finding by the Tax Court that the avoidance of surtaxes on shareholders was a "substantial factor" inducing

raised as to its scope and effect (Pet. 20; Br. 31-34), the fact of an accumulation in excess of the reasonable needs of the business has powerful probative force.

the accumulation of profits (Pet. 22, Br. 28-36). Even if that be so, the Board's finding that the taxpayer was availed of for the condemned purpose (R. 73) would seem to carry with it a determination that the avoidance of surtaxes was a substantial factor inducing the accumulation of profits. Such a finding is also implied in its express decision that the detailed findings "preponderate" (R. 100) in favor of the Commissioner's position that the corporation was availed of for the condemned purpose. It is true that the Board may not have regarded the tax motive as the only purpose. It was not obliged to do so.

In *Helvering v. Stock Yards Co.*, *supra*, dealing with the corresponding provision of earlier Revenue Acts, the practice of accumulating profits had been adopted before the first income tax was enacted. Nevertheless this Court held that if the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice, the Board's conclusion that the corporation was availed of for the condemned purpose was justified. 318 U. S. 693, 699. Therefore it would seem that if the avoidance of surtax was a reason, or one of the reasons, for accumulating gains, the requirements of the statute are met. There is nothing in the statute or in the decisions of this Court in the *Stock Yards Co.* case, *supra*, or in the *Nat. Grocery Co.* case, *supra*, to indicate that the Board must make an express finding that the avoidance of surtaxes

was a "substantial factor" inducing the accumulation of profits. Nor is there reason to believe that the Board applied any test different from that applied by this Court in those cases.

3. The taxpayer argues that the court below erroneously applied subdivision (b) of Section 102 of the Revenue Act of 1934 by treating the finding that profits were accumulated beyond the reasonable needs of the business as *prima facie* evidence of the existence of the condemned purpose surviving the introduction by taxpayer of evidence of the purpose inducing the accumulation, and that this conflicts with the decision of the Ninth Circuit in *Hemphill Schools v. Commissioner*, 137 F. 2d 961 (Pet. 22-23, Br. 32-36). But whatever may be said as to the operation of subdivision (b) or the decision in the *Hemphill Schools* case,⁸ the controlling fact here is that the Board's determination plainly depends upon the evidence alone, unaided either by the "presumptions" established by Section 102 (b) or the more general presumption of correctness which attaches to determinations of the Commissioner of Internal Revenue. After discussing in the first part of its opinion (R. 89) the *prima-facie*-evidence test provided by subdivision (b), the Board then considered the evidence without regard to

⁸ In fact, it appears that the Ninth Circuit in the *Hemphill Schools* case was referring to the presumption of correctness which supports the Commissioner's determinations in tax cases generally rather than to the force of the "presumption" of subdivision (b), once an adequate factual basis has been laid for it. See 137 F. 2d at pp. 963-964.

presumptions or even burden of proof (R. 97-100). The Board observed in this connection (R. 97):

But forsaking narrow procedural matters such as presumptions and burden of proof, we can not read the record as a whole without being satisfied that a preponderance of the evidence affirmatively establishes that petitioner was "availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting gains and profits to accumulate instead of being divided or distributed."

It is therefore unnecessary to consider the scope of subdivision (b), and the claim of conflict is groundless.

CONCLUSION

The decision of the court below is correct. There is no conflict of decisions. The petition for certiorari should be denied.

Respectfully submitted.

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DECEMBER 1943.





APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

(1) 25 per centum of the amount of the adjusted net income not in excess of \$100,000, plus

(2) 35 per centum of the amount of the adjusted net income in excess of \$100,000.

(b) *Prima Facie Evidence.*—The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax.

(c) *Definition of "Adjusted Net Income."*—As used in this section, the term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but diminished by the amount of dividends paid during the taxable year.

(d) *Payment of Surtax on Pro Rata Shares.*—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing

their returns) in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

* * * * *

Treasury Regulations 86, explaining the Revenue Act of 1934:

ART. 102-1. *Taxation of corporation formed or utilized for avoidance of surtax.*—Section 102 imposes a graduated income tax or surtax upon any domestic or foreign organization formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting gains and profits to accumulate instead of dividing or distributing them. * * * The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed

or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation. The surtax is in addition to the taxes levied upon corporations generally by Title I. For the computation of the surtax see article 102-4.

ART. 102-2. *Purpose to avoid surtax.*—

The Act provides two prima facie presumptions of the existence of a purpose to avoid surtax. The fact (1) that any corporation is a mere holding or investment company, or (2) that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, constitutes prima facie evidence of a purpose to avoid the individual surtax. * * *

The assumed purpose to avoid the individual surtax is subject to disproof by competent evidence like any other question. Proof of the purpose, therefore, depends upon the particular circumstances of each case. In other words, the purpose may be evidenced by circumstances other than the presumptions specified in the Act. A corporation is subject to taxation under section 102 when it is formed or availed of for the purpose of preventing the imposition of the individual surtax regardless of whether it is a mere holding or investment company, or whether the accumulations, if any, are in excess of the business needs. On the other hand, the statutory presumptions will be overcome if the corporation can show, by a disclosure of all the facts, that it was neither formed nor availed of for the purpose of avoiding the individual surtax, but the mere fact that it distributed a large portion of its earnings for the year in question is not sufficient to overcome the presumption. All the circum-

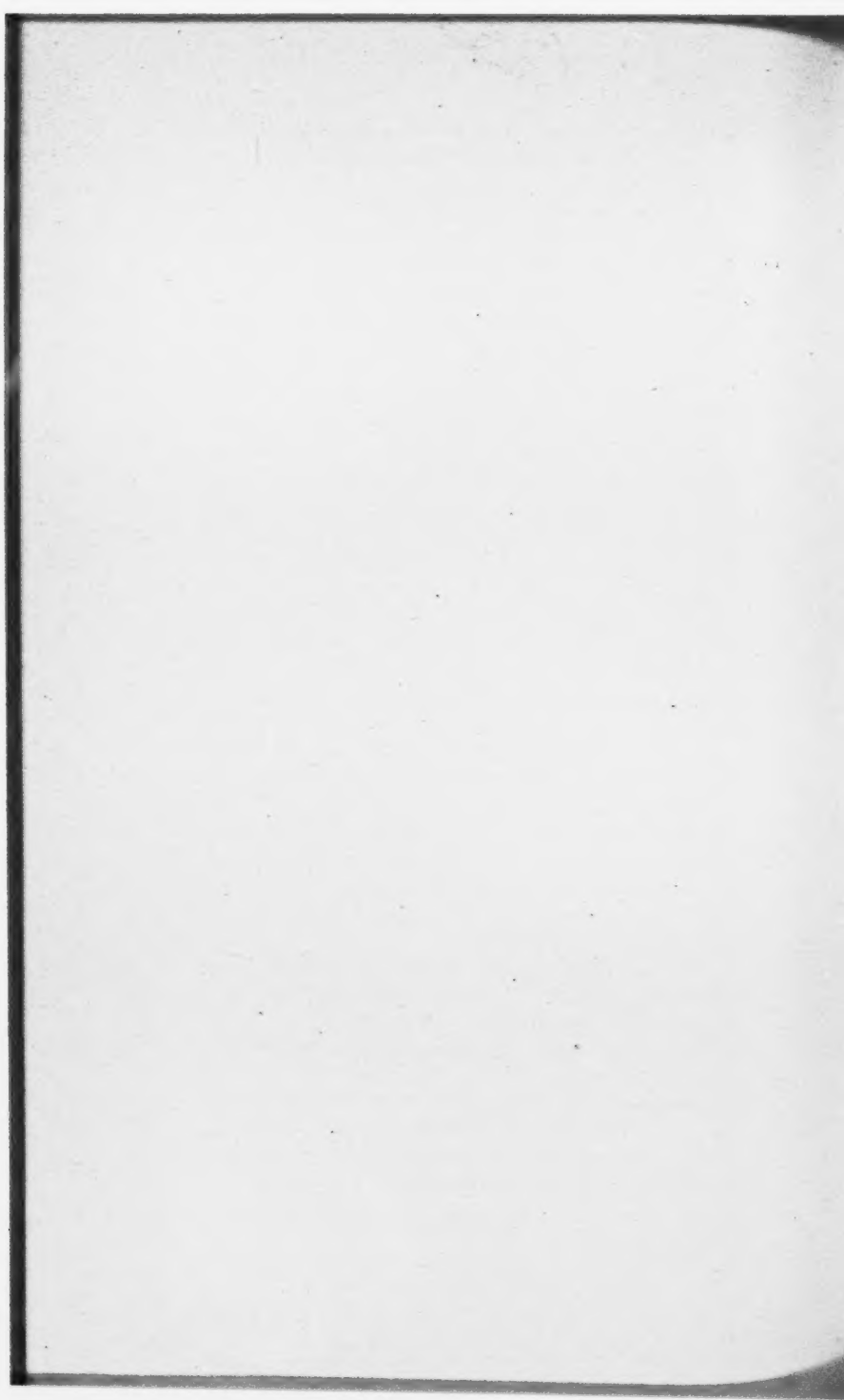
stances which might be construed as evidence of the purpose can not be outlined. Among other things the following will be taken into consideration in determining the existence of such purpose: (1) Dealings between the corporation and its shareholders such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business.

ART. 102-3. *Unreasonable accumulation of profits.*—An accumulation of gains and profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonable required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistrib-

uted earnings or profits will be considered in determining the reasonableness of the accumulations.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business.

The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).)



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CHARLES ELMORE CROPLEY
CLERK

Supreme Court of the United States

OCTOBER TERM, 1943.

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No. 490.
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TRICO PRODUCTS CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

**PETITION FOR REHEARING OF PETITION FOR A WRIT
OF CERTIORARI TO THE CIRCUIT COURT OF
APPEALS FOR THE SECOND CIRCUIT.**

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.



Supreme Court of the United States

OCTOBER TERM, 1943

No. 490

TRICO PRODUCTS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REHEARING.

*To the Honorable the Chief Justice of the United States
and the Associate Justices of the Supreme Court of the
United States:*

A rehearing is respectfully requested of petitioner's application for a writ of certiorari to review a judgment of the Circuit Court of Appeals for the Second Circuit, which this Court denied on December 20, 1943.

Rehearing is requested because the case involves a clear-cut question of law as to the proper construction of Section 102 of the Revenue Act of 1934 (48 Stat. 702). The question of statutory construction involved is an important one in the administration of the revenue acts, which should be passed on by this Court. We respectfully submit that the Court did not intend by its decision in the case of *Dobson v. Commissioner of Internal Revenue* (December 20, 1943)

to foreclose consideration by this Court of important questions of statutory construction of this type.

The judgment of the Circuit Court of Appeals for the Second Circuit affirmed a decision of the Tax Court finding a deficiency in petitioner's corporate surtaxes for the years 1934 and 1935 in the aggregate amount of \$1,617,931.89. Under the statute such surtaxes can be imposed only where the corporation is found to have been

“formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed
• • •”

As shown by its opinion, the Tax Court sustained the Commissioner on that essential point on the basis of a construction of the statute which the petitioner contends to be erroneous.

The questions of law involved were stated as follows in the Government's brief in opposition to the petition for a writ of certiorari (p. 2):

“QUESTIONS PRESENTED

• • • •

“2. Whether the Board of Tax Appeals erred (a) by failing to make an express finding that the purpose of avoiding surtaxes was a *substantial* factor inducing the taxpayer's accumulation of earnings, or (b) by misapplying the presumption established by subdivision (b) of Section 102 of the Revenue Act of 1934.” (Italics ours.)

These questions are of great practical importance to active business corporations in conducting their affairs with reference to war and post-war conditions.

This Court should review and reverse the lower Courts' construction of the statute as authorizing the imposition of corporate surtax liability in the absence of a finding that the purpose of preventing the imposition of individual surtaxes on shareholders was a substantial factor in inducing accumulations by the corporation.

The Government stated in its brief in opposition to the petition for a writ of certiorari that "the Board's finding that the taxpayer was availed of for the condemned purpose (R. 73) *would seem* to carry with it a determination that the avoidance of surtaxes was a substantial factor inducing the accumulation of profits" (p. 14—italics ours). This is a virtual admission that the statute requires such a determination. The actual opinion of the Tax Court, however, shows that its finding of the condemned purpose was *not* predicated on a determination that tax considerations had been a *substantial* factor in inducing the accumulation. Thus the Tax Court stated that the petitioner's evidence must be directed to the establishment of "the complete lack of the condemned purpose * * * and if it does not fairly prove an absence of such purpose, it must fail regardless of what other purposes it may prove" (R. 89); that a demonstration by petitioner of "the complete innocence" of its purpose is required (R. 89); and that petitioner is subject to the tax unless the Court is convinced that the stockholders "never * * * allowed their purposes to stray" to tax savings (R. 95) and that there had been "no taint of a purpose" to avoid surtaxes (R. 98).

It is apparent that the Tax Court did not find, or purport to find, that the prevention of surtaxes was a substantial factor in inducing the accumulations in question. On the contrary, it misconstrued the statute as imposing the tax unless this factor was wholly absent.

The decision below on this point directly conflicts in principle with the decision of this Court in *United States v. Wells*, 283 U. S. 102 (1931), construing a statute imposing taxes on transfers made "in contemplation of death." The Court there held that "the words 'in contemplation of death' mean that the thought of death is the impelling cause of the transfer," and that liability attaches only where the contemplation of death was "a controlling motive" or "inducing cause."

Nothing in the opinion of this Court in the *Dobson* case indicates any reason for denial of review in this case. Any general desirability of not disturbing decisions of the Tax Court must of course yield to the necessity for correcting such decisions if inconsistent with controlling principles laid down by this Court. Presumption that the determination of the Tax Court should stand because involving complex questions relating to a highly specialized subject has no application where, as here, the question of law is simple. The question is simply whether (a) as the Tax Court thought, the corporation must prove a complete lack and absence of any taint of the condemned purpose, or (b) as petitioner contends, the condemned purpose must be at least a substantial cause in inducing the accumulation. The Circuit Court of Appeals did not deal with this problem, but simply stated that it could not "subscribe to the view that the prevention of the imposition of surtaxes must be shown to have been the *dominant* factor behind the accumulations" (R. 374-5). It overlooked the fact that the Tax Court had failed to find that the prevention of the imposition of surtaxes had been even a *substantial* factor behind the accumulations.

Under the Tax Court's construction of the statute, a **taint of the condemned purpose** can always be imputed to

the controlling stockholders. In every case there will have been accumulations which, if distributed, would have increased the surtaxes currently payable by the stockholders. The corporation is thus deprived on this construction of the right to protect itself against the liability by showing that the actual purpose in inducing the accumulations was other than that penalized by the statute. It is submitted that no such result was intended under the statute, and that this Court should review the case and reverse the decision of the courts below thus based on an erroneous construction of the statute.

The second question of law referred to in the Government's brief in opposition to the petition for a writ of certiorari was whether the Tax Court had erred "by misapplying the presumption established by subdivision (b) of Section 102 of the Revenue Act of 1934." Subdivision (b) provides that "The fact * * * that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax." It is clear under a proper construction of the statute that upon introduction of evidence as to the actual purposes inducing an accumulation, the effect of the accumulation as prima facie evidence of the existence of the condemned purpose disappears completely. See *Hemp-hill Schools, Inc. v. Commissioner*, 137 F. (2d) 961. The accumulations in the present case were fully explained by petitioner, but the Tax Court nevertheless gave weight to the artificial statutory presumption.

The Government contended in its brief in opposition to the petition for a writ of certiorari that the Tax Court based its decision in the alternative on a finding that "a preponderance of the evidence", without reference to the

statutory presumption, established the existence of the condemned purpose (pp. 15-16). However, the Tax Court's reference to the "preponderance of evidence" (R. 97) is misleading because the record presented no evidence to support the finding of the condemned purpose other than the accumulations beyond what the Tax Court deemed to be the reasonable needs of the business. (See pp. 31-33 and 38-43 of petition for writ of certiorari.)

In any event the Tax Court's misconstruction of the statute wholly vitiates its statement that its finding of the existence of the essential fact was based upon a "preponderance of the evidence," because it misapprehended what the essential fact was. The Court believed that the statute imposed liability unless the taxpayer proved a complete absence of the condemned purpose, whereas under a proper construction of the statute the condemned purpose must be a substantial factor in inducing the accumulation.

The decision below is of far-reaching importance and application, and involves questions of law which have not been, but should be, settled by this Court. The tax is applied for the first time to an active business corporation having hundreds of stockholders, paying large dividends, and making no loans to stockholders. The tax is imposed on the theory that it is necessary to do no more than infer that the condemned purpose was not completely lacking, and that this inference may be based merely on the conclusion of the Tax Court as to accumulation beyond reasonable business needs, with no affirmative evidence of the existence of the condemned purpose, and in the face of a full, reasonable and inherently probable explanation of the accumulation by the taxpayer. The result is to place every corporation in jeopardy of very heavy penalties in every

case where there is room for difference of opinion as to the reasonable present and future needs of the business. This is contrary both to the intention of the statute and the economic interests of the country, particularly in view of the present necessity that corporations retain adequate reserves with which to meet post-war problems of reconversion and reemployment.

Conclusion.

For the foregoing reasons it is respectfully urged that this petition for a rehearing be granted, and that the judgment of the Circuit Court of Appeals be, upon further consideration, reversed.

Respectfully submitted,

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.

Certificate of Counsel.

We hereby certify that the foregoing petition is presented in good faith and not for delay.

ARTHUR A. BALLANTINE,
GEORGE E. CLEARY.